

COMER

\$3.95

Vol. 20, No. 2 • FEBRUARY 2008

CONTENTS

- 3 Bank of America Provides the Ultimate Blow
- 4 The Real Alternative to Tribal Politics
- 5 Assessing the New Fed Chieftain's Handling of Wall Street's Deepening Crisis
- 6 COMER Foretold the Current Subprime Debt Crisis Over Five Years in Advance
- 7 How Deregulation is Doing in Japan
- 9 Getting to Know the New Monsters that Roam
- 10 Paradox of Paradoxes — Too Aggressive a Foreign Policy Translates to a Slavish Dependence on Foreign Government Funding
- 11 Base Metals Mining About to Follow the Pattern of the Oil Trust
- 13 The Cost of Spin-Doctoring for Our Banks is Rising
- 14 Banks' Margins Shriveled
- 15 Has France, Too, Climbed Aboard the Fast Express to Hell?
- 17 Corporations Turn Cannibal
- 18 Completing the Moral of the Record
- 19 The Economic Topography is Changing Beneath Us
- 20 The Art of Banking in India

Subprime and Superprime

In its special way the murky subprime banking situation is uniting the world. It leaps barriers and oceans. Elegant French banks become as hopelessly tied up in money problems brought on by fancy derivative constructs as might a heavily drinking village grocer. *The Wall Street Journal* (22/1, "Bank of China's Subprime Hit? Up to \$2 Billion") reports: "Bank of China Ltd. is likely to report a large write-down on its investments in US mortgage securities, illustrating the broadening reach of the global financial downturn, and how one of China's biggest lenders was less astute in avoiding the problem than it initially thought. Analysts estimate that the state-owned lender, traditionally the most international of the country's big banks, may have to write off a quarter of the nearly \$8 billion it holds in subprime mortgages."

In Britain the housing market is feeling the sting of subprime mortgages, and financing is becoming difficult to obtain.

Efforts are being made to generalize the phenomenon and track it towards its possible source. The same issue of *WSJ* ("Risk Rises on Hybrid Securities" by Aparajita Saha-Bubna) reports: "Hybrid securities have in the past been an easy source of capital for cash-strapped financial institutions." The important word there is "easy." It refers to a diversion around the usual screening of borrowers for their credit record. Somehow under the cloak of "risk management" what was sneaked in there was in fact supposed risk-management that consisted in passing on the dubious debt unscreened to the legendary "bigger fool" also known as "bankers' exit." That made it possible for those who drove the system to indulge in an easier life, at the eventual expense of the next fellow in the lender line. For the banks the

important point is that it got most evaded problems off their own books, while commissions earned putting such deals together stayed with them.

But now the supposedly managed flow of risk has stalled. Banks all over the world are choking with that development. But since there is often a postponed upward adjustment of interest payments to many of such mortgages, the worst is still to come, and when it does, the mortgagor more frequently loses his home, and the property, left abandoned often becomes vandalized of plumbing, siding, fixtures, whatever.

The press is filling up with the plight of the people who have not only lost their new homes, or had to rent them out to tenants to meet the postponed higher payments. They suddenly find themselves with their life savings gone, reduced in their self-indulgence during boom times and their self-esteem. Nor can it stop there. The housing crisis cannot but leave its imprint on the already stalling economy.

A Superprime Economy is Forming

Meanwhile comes the downgrading of the bond insuring companies. Thus ACA Capital Holdings Inc., parent of bond insurer ACA Finance, obtained more time from its trading partners to work out its problems." The mortgage insurance firm mentioned has been given until February 19 to find a solution to its problems. These cannot be considered trifling; they involve "forking out" of \$1.7 billion.

Yet elsewhere at the same time, a process of creating a superprime economy is afoot.

If we withdraw from the fray long enough to find our bearings in all this, we will note that while the creators of the spreading

Continued on page 2



FOUNDING EDITOR
John Hotson 1930–1996

PUBLISHER–EDITOR
William Krehm
 (comerpub@rogers.com)

CARTOONIST
Allen Good

INFORMATION SECRETARY
Herb Wiseman (herbwise@cogeco.ca)

WEBMASTER
John Riddell

Economic Reform (ER)
 (ISSN 1187–080X) is published monthly
 by COMER Publications
 245 Carlaw Avenue, Suite 107
 Toronto, Ontario M4M 2S6 Canada
 Tel: 416-466-2642, Fax: 416-466-5827
 Email: comerpub@rogers.com
 Website: www.comer.org

COMER Membership: Annual dues
 (includes *ER* on request plus 1 book
 or video of your choice), in Canada
 CDN\$50, foreign US\$45

Economic Reform Subscription only:
 One year, 12 monthly issues, in Canada
 CDN\$30, Foreign US\$35

Send request and payment to:
 COMER Publications
 245 Carlaw Avenue, Suite 107
 Toronto, ON M4M 2S6

ER Back Issues: CDN/US\$4, includes
 postage; additional copies same
 issue, \$2; additional issue same order,
 \$3. Send requests for back issues to
 Herb Wiseman, 56 Robinson Street,
 Peterborough ON K9H 1E8.

**Copyright © 2008
 COMER Publications
 All rights reserved**

Permission to reproduce is granted
 if accompanied by:
 "Copyright © 2008 COMER Publications.
 Reproduced by permission of
 COMER Publications"

Publications Mail Agreement 40018485.

Postmaster, please send address
 corrections to:
 COMER Publications
 245 Carlaw Avenue, Suite 107
 Toronto, Ontario M4M 2S6

LAYOUT
 Tony Koch (comer@pagecraft.org)
 Pagecraft Computer Services

PRINTING AND DISTRIBUTION
 Watt Solutions Inc., London

Printed in Canada on recycled paper.



Subprime *continued from page 1*

subprime economy were doing their thing, other forces have been hunkering down with a control of the real economic values.

The *WSJ* (22/01, "Mining Titan Vale Courts Xstrata Fueling Industry's Consolidation" and "BHP Unlikely to Raise \$99.22 Billion Bid for Rival Rio Tinto by a Feb. 6 Deadline" by Robert Guy Matthews) informs us that the giant recently expanded world-spanning mining firms are not pausing in acquiring what major metal deposits they have not already picked up. It is as though, having grasped what is happening in the subprime non-economy that is taking over, they are entrenching in what basic giant mineral resources that are still undeveloped in the world. Elsewhere in this issue we provide some detail of the phenomenon. What concerns us is to put that phenomenon in its very intimate relationship with the subprime phenomenon. And the interesting detail is that for the execution of their grand plan the ultra-mega-concerns need the banks, for financing. But the banks have drugged themselves to being on the brink of becoming non-compos with the sub-prime derailment.

It illustrates the necessity of a well-run, controlled, non-globalized and non-de-regulated banking system that will provide essential banking services, neither more nor less to the economies of nations.

This brings us back to some of the ideas that we were concerned, and views on money that we in COMER dealt with 8 and a half years ago warning of just this fatal scission that was taking place in the way economists were doing their thinking. I believe it is important enough to quote from Volume 2 of *Meltdown*, the second of four volumes of *Meltdown*, a summary of the most interesting contents of *Economic Reform* during the near 20 years of its existence.

Reaching to the Linguists to Help Understand Money

What we quote is a summary taken from *Economic Reform* of September, 1999, and is to be found on page 52 of *Meltdown 2*:

In the May (1999) issue of *ER* I quoted a passage from Doug Henwood's "Wall Street" in which he cites Baudrillard, a French sociologist.

"On what is loosely called the left, such as it is these days, two unhappy attitudes towards finance prevail – one, that everything's changed and capital-no-longer-matters school; and two, a stance of uniform condemnation. An example of the first is

this silly but representative eruption from Jean Baudrillard: 'Marx simply did not foresee that it would be possible for capital faced with the imminent threat to its existence, to transpoliticize itself, as it were, to launch itself into an orbit beyond the relations of political contradictions, to make itself autonomous in a free-floating ecstatic and haphazard form, and thus to totalize the world in its own image. Capital (if it may still be so called) has barred the way of political economy, and the law of value. It is in this sense that it has successfully escaped its own end. Henceforward, it can function independently of its former aims, or absolutely without reference to any aims whatsoever. Money is now the only genuine artificial satellite. A sure artifact, it enjoys a truly astral mobility, and it is instantly convertible. A true artifact, it enjoys a truly astral mobility, and it is instantly convertible. Money has now found its place, a place more wondrous than the stock exchange, the orbit in which it rises and sets like some artificial sun.

"This displays an understanding of finance apparently derived from capital's own publicists. Like George Gilder, who celebrates the obsolescence of matter and the transcendence of all the old hostile relations of production, cybertopians and other immaterialists are lost in a second and even third-order fetishism, unable to decode the relations of power behind the disembodied ecstasies of computer trading."

Overtones of a World Coming Apart

This brought me the comment from our readers that Baudrillard must have been writing ironically. But there was more than irony in that passage. It had overtones of a world coming apart that was eerily familiar – our own world in fact.

If you have any doubt, consider this passage from *WSJ* (19/07/99) by Andy Kessler, "The Upside-Down World of High Tech." Under the subhead, 'You can sell products below cost and still make money,' Amazon.com created a great business selling books and other stuff online for a lot lower margins than traditional retailers who pay rent. In a flash, market share is taken and millions in market value is created. Strangely, in another flash, the next wave emerges: online companies that sell product at zero margin and gulp the negative gross margin. Can they make money? Sure. Buy.com in Alto Viejo, California, figure they can leverage the increased volume and traffic of customers by selling ad space, and getting

kickbacks from manufacturers. They can do Visa kiting by collecting Visa card payments in three days, and paying vendors in 90. On billions in sales, maybe they can live on, say, 1% profits. Once you get this model effected, it becomes a dangerous weapon.”

Linguistics Provides Vital Clues

Baudrillard was clearly a writer to look into. I had referred to him as an economist, and my correspondent questioned that. In fact he turned out to be a sociologist of the semiological tendency – that studies the relationship of signs with reality. As an ex-Marxist who has worked his way beyond Marx, he does know his economics. A great deal of imagination but no little stretch enters his visions: like all semiologists, he does tend to cover the whole range of human experience. Yet they do tend to come up with some highly suggestive results.

During the sixties in my excitement in discovering the writings of François Perroux, I did considerable reading on what was afoot in France and developed a passing acquaintance with Levy-Strauss and other French sociologists. Today Perroux is dead (1903-1987) and his important work is next to forgotten even in France. There the “Washington Consensus” as though with a gigantic broken Coca-Cola bottle has thoroughly raked the economic scene. But the semiologists, whom I had lost track of, have survived and come up with some amazing intuitive insights.

The school traces its origins to the father of 20th century linguistic theory, the Swiss Ferdinand Saussure (1857-1913). Described as ushering in a “Copernican revolution,” seeing men’s words as “peripheral tools,” he saw the understanding of reality “revolving around their social use of verbal signs. The concepts we use are creations of the language we speak.”¹

Saussure’s insight into the relationship between symbols and what they refer to has led Baudrillard to the following summary of what has happened with the economy: “The two dimensions are distinct, but articulated; i.e., they work together and cohere – a view that characterizes the ‘classical’ configuration of the linguistic signs. At this ‘classical’ stage of signification, there is a complete parallel with the mechanism of value in material production as Marx described it. Use-value functions as the original goal of the system of exchange value. It refers to the role of the commodities in the process of being consumed. Exchange value, on the other hand, relates to the interchangeability of all

commodities under the law of equivalence.

“A revolution has put an end to this ‘classical economy,’ a revolution, which beyond the commodity form stretches value to the most radical limits.

“In this revolution, the two aspects of value which sometimes used to be thought of as coherent and eternally linked, as if by natural law, are disarticulated.

“The structural dimension gains autonomy, to the exclusion of the referential dimension. Gone are the referentials of production, signification, affect, substance, history, and the whole equation of the ‘real’ contents that gave the sign weight by anchoring it with a kind of burden of utility.”²

“Concerned primarily with language Saussure nonetheless put his finger on the deeper roots of the alienation of economic theory from the real world. Marginal value theory introduced over a century ago drew

attention away from the ugly social reality that had surfaced in the Paris Commune. In a commodity, the relation of word, image or meaning and referent is broken and restructured so that its force is directed not at the referent use value of utility but to desire.

“The misapplied mathematics of marginal utility is the genetic code that made possible the present monstrous explosion of the financial sector.”

Elsewhere Baudrillard has described exchange value and its various derivatives as going into an orbit of hyper-reality.

For readers of an analytic bent, this is exciting material.

William Krehm

1. Baudrillard, Jean (1993). *The Transparency of Evil* (Trans. James Benedict, pp. 10, 11, 33), New York: Verso.

2. de Saussure, Ferdinand (1999) *Course in General Linguistics*, Charles Baily and Albert Sechehaye, translated by Roy Harris) London, Duckworth, p. 18.

Bank of America Provides the Ultimate Blow

The Wall Street Journal (11/01, “Bank of America Bets on a Recovery” by David Reilly and Peter Eavis) tells a most amazing tale: “Kenneth Lewis’s move to buy hobbled mortgage lender Countrywide Financial Corp., risky to be sure, is a bullish bet on the Bank of America’s own future and that of the battered financial system.”

That is quite a mouthful when you are referring to the head of the largest of all US banks. It took a long fall down stairs before the apparently almighty were reduced to such public embarrassment. And no one is yet on the horizon in the process of suing *The Wall Street Journal* for defamation.

“The chief executive’s [of Bank of America] balance-sheet may banish, at least momentarily, worries about Bank of America’s balance-sheet strength, separating it from many beleaguered peers. While Bank of America was never thought to be in as dire straits as Citigroup Inc., investors have feared that any big financial institution could be forced by big mortgage-linked losses to raise capital either by seeking outside investment or cutting dividend payments.

“These fears have dragged down Bank of America’s stock along with the wider financial sector. Earlier this week, Bank of America’s shares fell to new 52-week lows and plumbed levels unseen since the first half of 2004.

“But no investors on the New York Stock

Exchange took heart in the Countrywide news, pushing up Bank of America’s stock 56 cents or 1.5%, to close at \$39.30 yesterday. The possible deal was seen as positive for the wider financial industry and gave a lift to beaten-down financial stocks such as Washington Mutual which rose nearly 15%, and mortgage insurer MBIA, up 5.3%.”

A Contagion of Corporate Problems from Mortgage Investments

“Analysts have expected that Bank of America likely will write down the value of such securities by between \$4 billion and \$6 billion but hadn’t ruled out an even bigger hit.

“To be sure, a Countrywide deal, if completed, may prove too much of a reach for the acquisitive Mr. Lewis, who in August plunked down \$2 billion to essentially purchase Countrywide stock at \$18. The shares have recently traded below \$5. That shows that Mr. Lewis had at least once before misjudged Countrywide.

“In early trading yesterday news of a possible early acquisition Bank of America acquisition broke, Countrywide was trading at just 20% of its book value, as measured by the company as of September 30. It isn’t clear at what price a deal might take place, at anything near present levels, Bank of America would be buying the company at a big distance to its net worth. Some investors

felt that the lender was struggling mainly from a lack of money caused by severe credit market jitters. But others say that Countrywide had far more than funding problems and faced operating losses, lawsuits, write-downs and regulatory scrutiny.”

Operating on Fragile Ground

“In the third quarter, Countrywide took \$2.7 billion credit-created losses write-downs. Fears were mounting that the company’s inability to fund new loans, along with fresh hits to its capital position might prompt it to seek bankruptcy-court protection. Countrywide publicly denied that such a move was in the offing.

“The implications of such a deal to Bank of America’s own capital position are vital because the mortgage crisis and ensuing credit crunch have cast a cloud over the balance sheets of financial institutions generally. Bank of America’s fourth quarter write-downs, along with the completion of the Lasalle Bank Corp. deal in October, are likely to pull down its Tier 1 Ratio, an important measure of a bank’s financial strength, although it is not clear how much.”

It is indicative how close the world’s largest banks are to the very brink that the Bank of America’s possible designs on Countrywide, a bin of financial frailties or worse, would have been the theme of the issue of *WSJ* cited.

Also on the front page is another with the sub-heading “Blue-Chips Jump 117.78 as Deal, Fed Hints Life Stocks” by Peter McKay: “Hopes that the nation’s largest mortgage lender can be rescued from possible bankruptcy and aggressive interest-rate cuts can stave off economic recession drove the stock market to a day of solid gains. The Dow-Jones Industrial Average jumped 117.78 points or 0.9% over the last two days.

“‘We’re still on fragile ground,’ said trader Mike Mainwild of Lek Securities, a New York brokerage. People take it as a good sign that someone is willing to do a deal with a company in trouble. The main thing that changed a bit yesterday was psychology. People take it as a good sign that someone is willing to do a deal with a company in trouble.”

That could be a reviving sense of a common humanity, or it might also be that the

other party to the possible deal is in a bit of trouble itself.

In any case, “a *Wall Street Journal* report at about 2.15 that the Bank of America is in advanced talks with Countrywide Financial helped to drive major stocks sharply higher after major indexes had swung from gains to losses during much of the day.”

All in all word of the negotiations between Bank of America and Countrywide dangled daisy-chains of hope forcefully ripped from disaster. Still to be heard from, however, are the aggrieved, those left homeless as a result of subprime mortgage scams, and the authorities. Previous bailouts of the S&Ls, taken over by the banks in the US, and the relapse of world banking legislation to the deregulation and globalization of banking share many of the features of the banking models that had brought on the Depression of the 1930s. Since the 1960s we have had a series of reversions of the conditions that brought us back to the state of affairs that brought on the Great Depression, on an ever-crescendoing scale with no lack of military bugles blown to remind us where the deregulation of banking led us in the 1930s.■

The Real Alternative to Tribal Politics

While we have long since become accustomed to turning a critical eye on the rites of the American political process, we still have to show more penetrating critique in appraising our own. A striking example was the column of Lawrence Martin in *The Globe and Mail* (01/21, “Shaking up the system the new politics of Liz May”): “Elizabeth May is getting ready to rock the system. The only leader to see her party actually grow in support over the last two years, the Green Queen plans to offer Canadian a new brand of politics in the next elections.

“Her new war is to turn down tribal politics to strike a blow at the degrading blind partisanship of our system, and the continual lowering of the bar. To that end she will run not only on behalf of her Greens, but – as weird as it may seem – she’ll be plugging Stéphane Dion’s Liberals as well.

“Recall a year ago when she reached a mini-pact with the Liberals that involved their not running a candidate in the riding she is contesting in Nova Scotia? She has not soured on the Grits. Quite the opposite. ‘Where can we make the most progress?’

she asked the other day. ‘We can make the most progress with Stéphane Dion as Prime Minister in a minority government.... I believe that Dion’s record is a lot better than the other parties want to say it is. I’ll defend it.’”

The point is what you are talking about. What ladder Ms. May sees them climbing – the purely political one, or the one involving principles that the country desperately needs, and the pledge of each party to negotiate with the other rump parties, but be respectful of its own historic background. And above all defending what really significant contributions that party has made to our history.

Together or Apart?

In that perspective it may be more than “tribal politics” that would draw parties together or keep them apart.

The party of Stéphane Dion, happens to be the party of William Lyon Mackenzie King, and even more important of a Mayor of Vancouver, Member of the Commons in Ottawa and the Senate, who was able to convince PM Mackenzie King to national-

ize the Bank of Canada in 1938.

Decades before Maynard Keynes had completed thinking out how to attack the depression, but never quite caught up with the keen vision of this autodidact economist on our West Coast. In his great book, *The Conquest of Poverty*, he beat Keynes to Keynesianism and well, well, beyond, by at least a decade. He deserves that the current leader of his party, if we are to take him seriously, read and ponder the contents of that book. And then he should, if we are to take him seriously, explain why Canada finds itself in the ridiculous position of having on its law books the *Bank of Canada Act* just as it was drawn up in 1938, even though Brian Mulroney when still Prime Minister his own house Finance Committee turned down his proposal that the “zero inflation” and the independence of the Bank of Canada be put into the Constitution.

If Mr. Dion cannot take it up from there, where – if elected PM – is he going to find the funding to look after our threatened environment to keep Ms. May happy about environmental conservation?

W. Krehm

Assessing the New Fed Chieftain's Handling of Wall Street's Deepening Crisis

The New York Times Magazine (1/20, "The Education of Ben Bernanke" by Roger Loewenstein) assesses Federal Reserve Chief's record in handling the subprime mortgage mess. Mr. Bernanke was seemingly unmindful of the tools that served brilliantly to deal with the Depression of the 1930s. These policies, however, fit the spreading disaster of Wall Street's deteriorating position, like a long-established prescription. In this and many other aspects all citizens are stakeholders, no matter how unequally their respective stakes have been reapportioned in recent decades.

"Bernanke came to his [present] job [as head of the Federal Reserve] with a refreshing humility – a desire to be less an oracle like Greenspan than a plain-speaking technocrat. One line from his 'Essay on the Great Depression' sounds especially prescient today: 'To the extent that bank panics may interfere with normal flows of credit, they may affect the performance of the real economy.'

"His hero, Milton Friedman, is said to have warned against an indecisive Fed acting 'like a fool in the shower fumbling with first the hot water and then with the cold.' Perhaps, worst of all, he has failed to persuade investors that the Federal Reserve, formed in 1913 for the very purpose of halting market panics, is up to the job. 'Bernanke is seriously behind the curve,' says David Rosenberg, chief North American economist for Merrill Lynch, one of many critics who maintain that the Fed has not responded to this mega-crisis.

"For Bernanke, who is now 54, it has been an education unlike any at his university, MIT. The present problem is a hangover from a half decade of heady speculation in both housing and home mortgages and does not necessarily admit to a speedy fix."

In actual fact there was no "speedy fix" to the decade of Depression or the problems of refinancing the war and its devastation on several continents. It was just that all factors contributing to the problem were then considered. Washington at that time had ears for all suggested solutions.

The New York Times Magazine on the other hand opens its discussion with the remark. "Bernanke also has strong reasons to worry about [interest] rates too much.

Inflation has failed to fall as the Fed had expected. (In fact, lately it has been rising.)"

"Inflation," however, ought not to be a synonym for any rising price level. If prices go up because there is too much demand to be satisfied by the available supply of commodities traded that is truly "inflationary." But prices may be going up for quite different purely structural causes.

A Simple but Powerful Math Test

We have all had to take hold of that principle in our everyday lives. Being run over by a truck may break your leg. But if you find yourself with a broken leg, you cannot reach the conclusion that you have been run over by a truck. Falling over a cliff could well have been the cause. Especially if you were wandering around with your eyes shut. You cannot waltz around with cause and effect propositions as you might in a ball room with a beautiful lady to whom you are determined to remain ever faithful. There are countless different ways in which your leg could be broken.

Likewise there is more than a single cause that might have pushed up our price level. The exhaustion of our oil resources could be a serious part of the cause and higher interest rates are going to make new oil production more not less expensive. Or the fact that we have become rapidly an urban society with educational and other needs and facilities that our parents had no inkling of. Nobody moving from a town of 10,000 to Paris or New York will expect his living costs to remain unchanged.

Why then can they expect prices to stay flat when a great part of our ever increasing population makes just that sort of move? And disregarding these other factors and raising interest rates, is not going to change matters. For that will most surely bring on deflation. that will give you a paralyzed economy, and perhaps a war or two, but will not do away with the rise of prices, no matter what which of many possible causes may have brought on the precise rise of prices in any given instance.

Why then would a reputable economist elevated to run the land not have straightened out such elementary problems of reasoning?

Because defining any rise in the price

level – no matter how different its cause may be – with inflation, and assuming that the one medicament against this universal malady is higher interest rates, serves those in the saddle. Interest happens to be the basic revenue of our banks and of money lenders in general. And the banking community is ever on the prowl for excuses to raise interest rates.

There used to be not a monopoly of interest rates for stimulating or reining in the economy. There was the benchmark interest rates in the US it was the "Fed funds rate" set by the Federal Reserve for overnight lending between banks, and the discount rate set by the Fed but the loan actually made by the Fed at a higher rate and for a longer period. But as an alternative lever of controlling the economy there were the statutory reserves. These was a portion of the deposits taken in by commercial banks from the public that in Canada had to be deposited interest-free with the Fed. These provided an alternative to using interest rates as sole means of controlling the economy.

On such statutory reserves the BoC paid no interest, for if interest were given, it would decrease the leverage of the arrangement for restraining or stimulating the economy. But in Canada since 1967 these statutory reserves could not be changed without a special act of Parliament. In the United States the statutory reserves continue, but interest is paid on these reserves only during the banks' business hours and as soon as the banks close their doors, the reserves are automatically shifted to an interest-paying account. The real effect of those reserves was to avoid bestowing a monopoly power position on interest rates which put power clearly and exclusively in the hands of the banks.

The deregulation of our banks to permit them to take over stock brokerages, insurance companies and mortgage firms – the other "financial pillars" has allowed our banks to apply the bank multiplier to the liquid reserves that these other "financial pillars" kept for the needs of their businesses. Now with the banks obtaining access to them they used them as the cash basis to which to apply the "bank multiplier" to their loans to the public. In 1946 the value of the "bank multiplier" had been 10 or 11 to 1. Rather than being spent into existence

as had been the case when the government had the interest-free statutory reserves that cost it nothing, by 2000 it had become closer to 400 to 1.

The logic in that arrangement was that it represented the former monarch's monopoly of coining and recoinning precious metals, that was an important source of government revenue. And since the banks today have been allowed to create over 95% of the money loaned into existence, that not only puts more power and wealth into their hands but has made it possible for the banks, which historically had the ability to lend out ten times the amount of money in their vaults or with the Bank of Canada, to take

over the other "financial pillars" and add the reserve they keep for the needs of their own businesses to the money base which serves them to lend out many hundreds of times the amount of money than they could have done with their own cash reserves.

This had happened on a modest scale before the Depression of the 1930s, and indeed was a major factor in bringing on a decade of deep Depression that led to World War II. That is why, under the *Banking Law* drawn up under Roosevelt, banks were not allowed to acquire interests in any of the other financial pillars – stock brokerages, insurance and mortgages. Economic theory has been largely reduced to keeping prices flat.

COMER Foretold the Current Subprime Debt Crisis Over Five Years in Advance

In editing the third volume of *Meltdown* that should be appearing in about three months (the second volume of *Meltdown* should be out next month) we have come across this clear spelling out of the current world-wide subprime credit mess almost five years before it happened.

In the February, 2002 issue of *Economic Reform* we wrote: "*The Wall Street Journal* (2/01/02, 'Despite the Recession Americans Continue to be Avid Borrowers' by Jason Sapsford) assured us: 'Ten months into the current recession consumer credit defaults and payment delinquencies are as high as they have been since the last recession a decade ago. This time around, however, lenders, who were quick to reduce the flow of credit during previous recessions, have left the tap wide open. That's allowed Americans to continue borrowing to pay for homes, cars and other big-ticket items, bolstering the weakened economy.' Most lenders are far better positioned to deal with open losses."

On which *ER* commented: "But are they really? The structures of negative wealth as Enron or the optic fiber giants weave their way throughout our financial institutions, but have still not been remotely totted up. They are not likely to be for years to come. Corresponding to the negative wealth, a negative accountancy has sprung up to fill a powerful market need, and a negative morality to enable that negative accountancy to operate.... All this is not unsymmetrical to the plague of terrorism disguised as re-

ligion....

"Over the past decade, lenders have been boosting their capital reserves, and they have learned to manage their risks more effectively. That is one way of looking at it. Another is-more relevant – is that of spreading a deadly epidemic like AIDS or small-pox. At the same time, powerful computers have enabled banks and other financial institutions to automate the process of assessing their credit risks and approving borrowers."

That pretty well covers it all. If heeded, these warnings could have spared humanity on all continents some ugly experiences that are still overwhelming us.

Instead of depending on consumer indebtedness, the way to combat a cyclical recession would have been for the government to undertake essential capital investments – physical and in human capital – financed through its central bank so that it would be virtually interest-free. But that would have been based on conscientious accountancy in getting essential public infrastructures in place. Behind it would be not the bad risk of consumers over their heads in debt, but the credit of society, in a healthier condition with essential public investment in education, health, environment and the people employed in such essential projects assuming bearable amounts of debt. It would be the wages earned from employment in such projects that would have turned the recession around and headed society in a positive direction.

William Krehm

For a decade the United States has been engaged in active warfare in Asia Minor and the former Yugoslavia. And there have been neither price controls nor other restrictions that are usually routine in warfare, no control of currency leaving the country for civilian ends, or on travel abroad. I will just mention other such samples of structural rather than market inflationary price rises.

Why Price Can't Behave Like a Pancake

Our average life span has increased substantially. That is a trend that should be celebrated with fife and drum, even though it must increase the price level in part because of the additional public services entailed and continued private spending.

Ours is a rapidly urbanizing world. Nobody moving from a town of, say 20,000, to New York City is fool enough to believe that his cost of living will remain the same. How then, can we expect price levels to do just that, when society as a whole is engaged in a similar move?

A city needs costly transportation, police, educational institutions, fire and other departments, health care, highly enriched educational system. That is what cities are about. Left inadequately serviced, cities become hell-holes inviting crime and disease. If fundamental principles of accountancy are violated, however, they can be made to appear as "fiscal prudence." Until January 1996, when the Department of Commerce statistics introduced accrual accountancy (a.k.a. capital budgeting) to depreciate the physical investment over its likely useful life instead of writing it off in a single year and then carrying it on the government books at a token dollar.

At the same time the public monies spent or the debt incurred to pay for these public investments until 1996 in the US and until 2002 in Canada were carefully amortized over the useful life of the investment. What previously had resulted was a breach of double-entry bookkeeping. It mattered not that a Royal Commission and several Auditors General had urged the government to adopt accrual accountancy, also known as "capital budgeting." Up to then the debt incurred for building schools, roads and bridges was written off in a single year and beginning with year 2 carried on the government books at a token dollar, while the debt incurred to buy or build the capital asset was carefully amortized on the other side of the ledger.

A seeming deficit occurred that was not

necessarily there. Unfortunately, when rectified, the depreciated value of the government's physical capital assets appeared under the heading of "Savings," which was inaccurate since, as economists use that term, it refers to cash assets readily convertible into cash – certainly not the case of perhaps century-old buildings or bridges. However, it is a doughtily defended principle of free-market folk that governments are incapable of making investments. They can only bail out speculative financial corporations on the average once every seven years or so.

It should be noted, moreover that, in the 1960s, a Bank of Sweden Nobel Peace Prize for Economics had been awarded to Theodore Schultz for his proof that investment in human capital is the most productive that a nation can make. This conclusion Schultz arrived at when he considered the contrary conclusion that he and hundreds of American economists sent to Germany and Japan at war-end to predict how long it would take for these defeated nations to resume their pre-war formidable roles as formidable exporters. In the sixties Schultz wrote that he and his colleagues had been so wide of the mark because they concentrated on the physical destruction in those two smashed-up countries, but ignored the key significance of their highly educated and skilled populations, which came out of the war basically intact.

Obviously treating such one-year write-offs of human investment as a current expense pushes up interest rates and adds needlessly to both the rate of interest and the amount of taxation that governments feel they must raise. It thus contributes to a higher price level in a non-linear way. Unless Mr. Bernanke and his critics start sorting out the different possible causes of rising price levels, we will not be able to sort out the ingredients of real inflation in our higher price levels, and distinguish it from structural price rises.

Accountancy Twisted Like a Pretzel

Accountancy, twisted like a pretzel, has served other ends of the high financial community. Buildings at strategic centers of our largest cities across the land were carried on government books at ridiculously low prices – until 2002 with accrual accountancy. Yet a few months ago building next to Union Station in Toronto and across the road from the most elegant contemporary buildings were put up for sale with a 25-year lease back by the government, on the pretext that the federal government could not afford

to maintain them properly. This from the mouth of a government that holds all the shares of the Bank of Canada. The only legal tender in this blessed land is the debt of the federal government, and yet even after accrual accountancy was brought into the federal books, the government holds parliament and the public in such contempt to make a statement like that. Even if our government did not own the Bank of Canada, and if its debt were not the only legal tender

in the land, any bank would fall over itself to finance the improvements that the government deems beyond its means. However, despoiling the public domain is accepted high sport and wisdom.

Though many of these buildings in themselves are historic, even the sites on which they stand are such that their value goes up whenever any level of government puts in fresh transportation infrastructure and whenever private developers build good

How Deregulation is Doing in Japan

The New York Times (5/12, "The New Japan, Rural Economies Wane as Cities Thrive" by Martin Fackler) reports some effects of globalization and deregulation pushed on Japan by Washington that threaten a new factor in the instability of the Far East.

"Noshiha, Japan – A proliferation of national chain stores outside town has already forced the closing of about half the city's once teeming central shopping district. Now, many in this normally restrained rural community see the mega-mall being built nearby by a company based near Tokyo as the final nail in the coffin of their economy. Said Seiji Yana Gihari, an official with the Noshiha Chamber of Commerce which opposes the mall, 'Tokyo is eating all the goodies, and not even leaving us with scraps from the table.'

"Japan's \$4.7 trillion economy has expanded for the past five and a half years. Urban centers like Tokyo and Nagoya, seat of the auto industry, are thriving, as seen in the building boom decorating Tokyo's skyline with glittering new highrises.

"But in regions like Akita, the mountainous northern prefecture, home to Noshiha, down-towns have emptied and factories have closed. An exodus of youths seeking jobs in Tokyo is leaving behind towns that are predominantly for the elderly.

"There is wide concern that these changes are turning Japan into a nation of winners and losers, split geographically between prosperous cities and depressed rural areas. Many here attribute this growing disparity to Japan's embrace of American-style economic liberalization, begun in the 1990s to end the nation's decade of stagnation.

"The measures to open up markets helped revive cities like Tokyo and lowered prices for Japan's long-suffering urban middle class. But elsewhere in Japan, they

are seen as bringing unwelcome change.

"And now with signs of a coming slowdown in Japan, divisions could deepen. On Monday, Japan's top central banker, Toshihiko Fukui, warned of Japan's largest overseas markets. He said he was particularly concerned about the impact on Japan's small and midsize companies, many of which are in rural areas.

"The new economic policies are blamed for undoing one of Japan's proudest achievements after World War II, the creation of an egalitarian society that was almost uniformly middle-class. They have also eroded one of the pillars of Japan's postwar political stability, rural voters' stalwart support for the ruling Liberal Democratic Party.

"The changes began during Japan's doldrums, when the government tried to revive growth by slowly but steadily deregulating swaths of the economy like banking, insurance and groceries. As seen in Noshiha, some of the biggest upheavals followed the lifting of restrictions on large stores, a step originally urged by Washington to admit American retailers."

In a country so tightly peopled as Japan, there must be great anxiety about what happens to land values, and considerable difficulty in understanding land price movements in more sparsely settled countries. When in the 1980s Japanese banks were investing heavily in US real estate to keep the yen competitively low, the misjudgments of some of the investment verged on the epic. They contributed in fact to the decade of practical immobility of their banks that constituted the decade-long hiatus in Japanese bank activities.

"Many opposition politicians now talk about halting or rolling back American-style liberalization to protect traditional ways of life."

W.K.

buildings in their vicinity. The Normans having conquered England made a point of leasing building sites for 100 years particularly where the roads left by the Romans intersected. They had an eye for real estate. And there were no banks around to provide mortgage financing.

Truth and honesty looking after the public interest are also subprime in our land.

Right here we must clarify something that was very obvious to most economists, but has simply been purged from key parts of our history – simply *verboden* to be mentioned. The Great Depression of the 1930s was begun with a tremendous stock market crash. In a matter of weeks the situation changed so drastically that there were actually financiers, industrialists and economists shifted from having predicted that a plateau of high stock market earnings that could make every American a millionaire, to advocating 100% money. The latter in essence meant doing away with banking and restricting banks to the role of intermediaries who – rather than issuing a multiple in loans of the cash they held in their vaults – would be allowed to lend out only what they held in their vaults. That was also known as 100% money, because banks could only lend out what they themselves owned or took in as deposits.

The Dearly Bought Lessons of the Depression are Buried

Since 38% of US banks had already shut their doors, one of the early acts of President Roosevelt was to declare a bank moratorium. Banks under the *Banking Act* brought in under Roosevelt were not allowed to acquire an interest in the other “financial pillars” – stock brokerages, insurance and mortgage companies. The reason was clear. The other “financial pillars” maintained their own pools of liquidity for the needs of their own businesses. Grant the banks access to these and they will use them as base money for applying the banking multiplier. In this way the distinction between legal tender held by the banks that had been created by the government spending it into existence, and interest-bearing money lent into existence by the banks was made vaguer, since the banks could transfer its credits from its brokerage or mortgage department to the banking sector and use that as the base for credit creation.

The same confusion turned up in the opening of a new type of account which both had chequing privileges and earned interest. Since this confused legal tender

that bore no interest – and hence was not affected in its value by movements of interest rates, and non-checking accounts that did. The former was legal tender, the interest bearing accounts on which cheques could be written earned a modest rate of interest, and hence responded negatively to any change in the benchmark interest rate. When the banks took over the other financial pillars, the distinction between money and near-money gradually disappeared. Indeed, all distinctions between the ever more varied activities that the banks had got into, tend to that. The result: the cash reserves of the non-banking firms the banks took over gradually intermingled with their legal tender reserves. The distinction between legal tender (government debt) and private debt was weakened and finally lost – there was a vast increase of speculative money seeking investment. What resulted was a huge jump in the multiplier, less and less well defined, and increasingly used for speculative takeovers as agents and principals.

That is how the subprime mess came into existence. Now this distinction was eliminated and what was left resulted was a plethora of money and near-money that sought investment. Every seven years or so, the banks used the plethora of money created by them on the basis of the reserves they took over from the brokerages, mortgage and insurance companies got them into trouble. For they were in unfamiliar areas, handling an excess of near money created on their own cash reserves and what they had acquired by taking over the non-banking institutions. All that money cried for profitable investment, and the banks thus became pioneer explorers finding more lucrative and more “efficient” investments – takeovers. Deregulation and Globalization proceeded relentlessly, hence contributed to the subprime mortgage mess.

For almost a decade COMER tracked this bank multiplier under the name of “Estimator.” From 11:1 in 1946, it rose steadily until 1938. It attained a value of 402:1 until the imminent stock crash throughout the world brought it down to the 380 figure.

We abandoned it because we were stretching the available data. Because the statutory reserves had been abolished by 1992, for the denominator of our ratio we were obliged to use the legal tender kept by the banks to meet the needs of their clientele through the ATMs and or via the teller. But that money was accordingly not available as a reserve supporting the money creation. It was earmarked for the needs of customers.

That and the new chequing interest bearing accounts smudged the distinction between bank-created “near-money” and legal tender that to qualify as relatively unaffected by movements of the benchmark interest rates. So with regret we bade farewell to our Estimator. By now we are certain that it would be somewhere around 1000 to one.

The relevance of this to the Bernanke piece in the *Times* magazine is that it shows the plethora of near money created that provided a key ingredient without which the subprime mortgage play could not have bloomed as lushly as it did.

The essence of the present difficulties with the American economy is that too much near money creation created by the banks; entry into the mortgage business clamoured not only for being invested, regardless of the quality of the investment, or the lack of it. To provide what is known as the “bankers’ exit” for this huge and ever increasing amount of near-money, it was packed and graded supposedly according to its quality. The important thing for the banks was to take their quick profit and not be stuck with it among their assets.

Nor did the financial servicing of these subprime mortgages fit the capacity for supervising them of the innocents on whom they were unloaded. Moreover, the subprime mortgages were packaged with mortgages of other grades and then cut into swaths, and the mortgage package was made to fit the capacity for risk-taking of the investor. Otherwise the banks were in no mood to be stuck with administering the mortgages. Indeed the mortgages were so entangled one with another that it could take many months and even years for those in charge to ascertain what the paying record of the mortgagor had been.

The entry of the banks into the other financial pillars was carried out in ways that allowed for essential operations to be done by service organizations – the mortgage agent was only the first of these. The alleged risk-management, for example, was supposedly seen to by bond insurance companies. “Before long the rating of the bond insurance companies dropped from triple A to double A, and in doing so the entire issues of the bonds insured by them decreased in value. What resulted was a contagion of down-grading, starting with subprime mortgage bonds going on to municipal bonds and before long undermining the creditworthiness of the entire field of securities based on collateralized debt obligations (CDOs).

W.K.

Getting to Know the New Monsters that Roam

While proofing Meltdown II we came upon the following article published in the September 2000 issue of ER. Amazingly it is a commentary on some excellent reporting that appeared in The Wall Street Journal of 25/07/2000 that tracked what was to blossom into the subprime debt theory right to Maggie Thatcher's "There is No Alternative" [TINA] that in fact turned out the mirror image of the Marxist inevitability of the proletarian revolution.

The next time somebody tells you that what COMER has to say is too difficult to understand, just pause and ask yourself what price you would in retrospect put on a timely grasp of the still unknown ultimate consequences of the sub-prime "risk management" which has cut the once most powerful financial conglomerates, and their central banks at the knees. From the false orthodoxies imposed by our governments and universities cures have still not been devised. The immediate task is to re-establish the freedom of analysis. That would once again make available the resources that are the essence of a democracy.

In the previous issue of *ER* we introduced one of John McMurry's characteristic insights: the militant right, having brought down the Evil Empire, has appropriated one of its key dogmas. The "inevitability of the victory of the proletariat" has been translated into "There is not Alternative to Globalization and Deregulation." What was formerly condemned as a violation of people's freedom has now been declared a matter to which "there is no alternative."

Entering a New Geological Age

With that we have entered a new geological age. What was seabed now turns up as mountains overhead. Obviously it would be a fatal mistake to assume that the palaeontological zoo is still around us. There is urgent need to study the hunting habits of monstrous new predators that have arisen. For this we are well served by *The Wall Street Journal* (25/7, "Subprime Asset – The search for the Bottom" by Carrick Mollencamp).

This sketches the shoddy reality of what had been hyped as the fastest growing bank of the land – one that grabbed up other banks without so much as a burp, the embodiment of efficiency through appetite, from the unpromising take-off point of Charlotte, NC. "For 27 years Edward E. Crutchfield Jr. was lord of First Union

Corp. He barrelled through 90 acquisitions, transforming First Union from a sleepily local bank into the nation's sixth largest.

"That explains the delicate issue that faced Mr. Crutchfield's protégé, G. Kennedy Thompson, when he was named president of First Union a year ago: how to deal with the evidence that his boss had made a major blunder? In June 1998 First Union had paid \$2.1 billion to acquire Money Store Inc., a big lender to people with poor credit histories and a constant presence on late-night TV. But within months of the deal, it was clear that something was terribly wrong. By late last year, the problems led Thompson to launch an examination of the unit that became known among First Union executives as the "Search for the Bottom."

The Perils of Growth at Any Price

"Last month, First Union's board voted to support a strategy unveiled by Mr. Thompson that reversed some of Crutchfield's biggest moves of recent years. First Union would shed ailing assets and embrace a new business plan. Money Store would be shut down, eliminating the jobs of 2,300 people. Two other businesses, mortgage servicing and the bank's credit card portfolio, would be sold. The net cost: \$2.8 billion, one of the largest charges ever taken by a US bank.

"Mr. Thompson's new blueprint for First Union carries risks of its own. It is building a nationwide financial institution focused on investment banking, asset management and retail and commercial banking. A licensed stockbroker will be posted to nearly every branch to advise customers on what stocks to buy or try to interest them in one of First Union's mutual funds. On Wall Street Thompson aims to make First Union an aggressive underwriter of stock offerings and backer of buyout deals. Money Store-style lending to high-risk consumers is out.

"Other banks have tried to compete with the likes of Merrill Lynch & Co. and Charles Schwab Corp. with limited success.

"Remaking the strategy of a man who created First Union was all the more wrenching because Mr. Crutchfield, 59 years old, has been diagnosed with lymphoma. Thompson agonized over how to fix First Union's most pressing problems without 'stuffing it in Crutchfield's eye,' says another First Union executive.

"Crutchfield took the helm of First Union in 1973, at age 32, and embarked on a plan to turn the company into a national powerhouse. [His] breathtaking buying spree earned him the nickname 'Fast Eddie' on Wall Street.

"Crutchfield thought Money Store offered expertise in lending at high rates to borrowers with past credit difficulties, a group bankers usually turned away. First Union also saw an opportunity to use its own investment-banking arms to earn fees by securitizing Money Store loans and selling them [packaged] on Wall Street."

At this point, the student of the new "one-stop banking" monsters must make a note: the logics of the different businesses that banks have come to engage in conflict too often with one another head-on. It used to be the job of retail bankers to assess the risk in every loan, and use that knowledge to track the behaviour of the borrower who stayed with them. But all that is gone. By securitizing the loans and selling them by the ton on Wall Street they save themselves the risk and cost of staff to keep an eye on their borrowers' uninspiring records. In short, they duck the hard work for which they had voted themselves a premium interest rate. All they seek is to unload onto the legendary "bigger fools." Whether they succeed in doing so or not makes a great difference to them individually. For the economy as a whole, however, either way credit gets pyramided responding to the model of the quick "bankers' exit." The bad loans, however, do live on in the hands of others not even equipped to supervise them.

The Star of Subprime Banking

Money Store was itself an epic of growth at all costs. Marginal theory sees price as the only value. And that it considers can be determined by how much demand can be whipped up by advertising to overwhelm supply with demand. That creates an ambiguity that is fly-paper to catch those legendary "bigger fools" that finally include the policy-makers themselves. By marginal theory higher prices *mean* greater "added value," but in reality they may merely reflect "greater risk," i.e., attest that the value is not there. That is the gene that ultimately produces the wonder of the dot-coms.

"Money Store was the star of the subprime lending world. Started in 1967 as a

small home-equity lender in New Jersey, it had grown into a major home-equity and small-business lender. It made \$5.9 billion of loans of this sort in 1997 alone. It packaged its loans into mortgage-backed securities, which it then sold to investors to

finance additional loans.”

Accountancy comes in a variety of styles, each suited to the nature of the beast that has taken over the hunting field.

“Money Store’s accounting methods, called ‘gain-on-sale accounting’ may have

masked problems. A normal practice for subprime lenders, the method allowed Money Store to book earnings from loans as soon as they were made, rather than waiting for them to be paid off, as banks typically do.

Paradox of Paradoxes — Too Aggressive a Foreign Policy Translates to a Slavish Dependence on Foreign Government Funding

Washington’s era of foreign military adventures has put it into a wall-building mode to keep out the Latin American immigrants on whom it depends increasingly to do the slugging, underpaid work of the land. Yet at the same time it is trying to cope with its deepening financial troubles with the help of foreign government financing (“sovereign funds”) of the sort that it had turned down as incompatible with its security interests just two years ago. *The Wall Street Journal* (25/1, “Lobbyists Smoothed the Way for a Spate of Foreign Deals” by Bob Davis and Dennis K. Berman) recounts a bizarre tale: “Washington – Two years ago Congress pressured the Arab emirate of Dubai to back out of a deal to manage US ports. Today Persian Gulf states, China and Singapore have snapped up \$37 billion worth of stakes on Wall St., the bedrock of the American financial system. Lawmakers and the White House are welcoming the cash, and there’s hardly a peep from the public.”

Subprime Debt and Accountancy have Created the Need for Foreign Financing of Washington

“This is no accident. The warm reception reflects millions of dollars in lobbying by both overseas governments and their Wall St. targets – aided by Washington veterans of both parties, including Republican big-time fund-raiser Wayne Berman. Also easing the way: the investments have been carefully designed to avoid triggering close US government oversight.

“US banks, deeply weakened by the ongoing credit crisis, clearly need the cash. Meanwhile investment pools funded by foreign governments have trillions to invest. And Washington, though suspicious of foreign governments, deems it suicidal to oppose aid to battered financial companies. ‘What would the average American say if Citigroup is faced with the choice between layoffs of 10,000 or more foreign invest-

ments?’ asks NY Democrat Sen. Charles Schumer, who played a central role in killing the Dubai port investment but has applauded the recent version of the same sort of thing?

“But by making investments by foreign governments seem routine, Washington may be ushering in a deep change in the US economy without assessing the longer-term implications. Some economists warn that these stakes could provide autocratic governments with an important say in how the US companies do business, or give them access to sensitive information or technology. People familiar with the government’s review processes say US military officials worry that a foreign government, especially China, may be able to coax an executive into turning over secrets.

“Former Treasury Secretary Lawrence Summers counsels that there should be a very strong presumption in favour of allowing willing buyers to take non-controlling stakes in companies, but it is imaginable that government-related entities investing in the US will be motivated to strengthen their national economies, making political points, reward or punish competitors, or suppliers, or extract know-how.

“Sovereign funds from Russia to the Middle East, meanwhile, are seeking opportunities.”

“In nearly every case, US financial companies are escaping detailed US government review by limiting the size of stakes they sell to government invest funds. The Multi-agency Committee on Foreign Investment in the US led by the US Treasury can recommend that the President block foreign acquisitions on national security grounds. Congress can block deals by pressuring companies or passing legislation.

“Under the CFIUS rules a passive stake – one in which investors don’t seek to influence a company’s behaviour – or is presumed not to pose national security problems. Nei-

ther is a small voting stake, usually of less than 10%. During the recent string of deals, usually of less than 10%. Financial companies meeting these requirements have not had to go through 30-day initial reviews.”

However, you do not have to be a dyed-in-the-wool cynic to take that as a measure of Washington’s desperate financial needs rather than of its civility – especially to small countries. If it stopped building walls to keep out desperate would-be emigrants whose homelands it has contributed to disrupt, it would improve its image. Perhaps the helpful point could be made if all its relationships with other peoples were seen in the light of an advertising or public-relations campaign.

Escaping Review

And, of course, it should do something about bringing back to the curricula in its universities the work of generations of good and even great economists who taught us how to work our way out of the Great Depression, finance a world war, and the reconstruction of the world. All that has been jettisoned to produce the execrable standing abroad of the great American nation today. I was about to say “and their bankers,” but I bit my tongue. Those bankers, crowned as the Neroes of our age, are at the root of our problem.

“As Wall Street thirsts for fast and huge capital infusions, sovereign wealth funds look like an oasis. These government-financed pools have about \$2.8 trillion in assets, which Morgan Stanley estimates could grow to \$12 trillion by 2015 as Middle Eastern funds bulk up oil receipts and Asian ones expand from trade surpluses.”

Unfortunately, the accountancy, budgeting, banking laws, and the foreign policies seem all focused to avoid their own accumulation of sovereign funds. That is leading to some very rending situations.

W.K.

“This perception calls to mind an observation of an anonymous sage: lenders addicted to sensational growth end up mimicking the habits and morality of their worst clients.”

The “Bigger Fools” Turn Up in the Wiz Kids’ Mirrors

“As interest rates fell in the fall of 1998, larger numbers of Money Store customers paid off their loans earlier than expect-

ed, slashing the company’s profit margins. Money Store responded by cutting its own rates and lending to borrowers with even more troubled credit histories. Making matters worse, the market for mortgage-backed securities dried up in the wake of financial chaos in Russia and other overseas markets. [This] left Money Store with the higher risks of many of its new loans. The ‘bankers’ exit’ suddenly closed. All the PR about ‘risk management’ turned to ashes. The ‘bigger

fools’ turned up in the financial geniuses’ mirrors.

“The first public sign that Money Store was a threat to First Union came in January 1999. It reported that its results of that year would fall short of the analysts’ expectations, because it was eliminating the gain-on-sale accounting system.”

That is the ultimate comment on the inevitability of TINA.

W. Krehm

Base Metals Mining About to Follow the Pattern of the Oil Trust

It is high time that the rest of us straightened out our thinking on what is inflation and what may simply be due to our exhausting the supply of ore bodies that the Good Lord left for us. And certainly raising interest rates to flatten out our heads and our thinking as our governments have been doing on the subject will be of little help.

But let’s lay out the basic facts first, and then we’ll go on to consider what is the wisest course to take in the interest of all stakeholders.

In a front page article of December 18, *The Wall Street Journal* (“Mining Companies Bulk Up, Echoing the Mergers of Big Oil”) observes: “‘If you look at the industry and the history of oil mergers, really the same game is playing out,’ says Alec Gorbansky, a managing director at Frontier Strategy Group – a Washington, DC, emerging market advisory group.

“Not all the forces that united oil companies were like those driving Big Mining today. Commodity prices were depressed in the late 1980s, and oil companies thought that merging would help them survive hard times. Today’s miners face the opposite challenge: prices are so high that natural resource companies have more cash than they know what to do with.”

Solving the Embarrassment of Having More Money than You Know What to Do With

“But the similarities are striking, say investors, bankers and analysts who study the sector. On the back of explosive growth in China and other developing countries, some mined commodities are taking on a strategic importance that is starting to rival that of crude. As with oil, most of the world’s high-grade mineral deposits have been tapped, leaving resources that are lower grade, hard-

er to reach or politically challenging in location. By merging, miners hope to tackle the complex projects that remain.”

And may we add that we must trim our attitudes to the reasonable views of many host countries who are perfectly aware that it is an ever more dwindling natural resource that they are consenting to be taken from their country. There was a time when any government that joined with other host mining countries to obtain fairer terms and less pollution might be overthrown by Washington. That occurred even when they were democratic, or in any case not under Communist influence. Canadians should today appreciate such attitudes of host countries, since we have recently experienced three of three major mining companies being taken over by the huge international mines.

“Many Western miners hope that their size and technical prowess will make them choice partners in countries such as Mongolia that need foreign expertise to develop their assets. Big Western mines are also bulking up to compete with new miners in countries like Russia and China.”

Nationalism in Host Lands Demands a Greater Share from a Departing Resource

“Size will also matter in an era of increasing resource nationalism. Much as Russia and Venezuela cracked down on oil companies’ access to local resources, the likes of India, Indonesia, and Bolivia are increasingly protective of their mineral resources.

Mega-miners with broad experience and well-known names could have more leverage to persuade such countries to open up to development. On the flip side, should host government decline to cooperate, big miners would have a portfolio of mines to fall back on.

“The Big Mining Era could result in higher profits for leading companies, much as consolidation boosted profits for Big Oil. But the trend could make life much more

difficult for consumers.

A few big companies could have the power to wait out market weaknesses and keep prices high by putting projects on hold.

“‘The more concentration you get, the more monopoly power you get,’ says Amy Jaffe, an energy studies fellow at Rice University’s Institute for Public Policy. Ms. Jaffe found that oil sector consolida-

tion resulted in less oil, not more from big companies. She suggests that’s because oil companies have spent money on dividends and share buy-backs at the expense of new exploration.

“Though a BHP-Rio deal (the two largest metal-mining concerns in the world – both Anglo-Australian) is far from certain, the overture is the product of broad forces that analysts say are driving consolidation across the industry. Billiton HP and Rio Tinto both date to the 1800s, when the predecessors developed mines in Australia and Spain. Over the years the companies grew through mergers and new mines to become two of the business’s largest players.

“Even without merger, prices [of iron ore] are expected to increase because of demand from China, India, and emerging countries. Steelmakers this year are expected to see prices rise more than 70% for iron ore” (*The Wall Street Journal*, 8/02, “BHP-Rio: A Regulatory Maze” by Robert Guy Matthews, Sebastian Moffett and Charles Forelle).

BookStore

Available from COMER Publications
245 Carlaw Avenue, Suite 107
Toronto, Ontario M4M 2S6
Price plus \$2.50 P&H or as indicated:

Hazel Henderson

- *Building a Win-Win World – Life Beyond Global Warfare*, \$15 + \$6
- *The United Nations: Policy and Financing Alternatives: Innovative Proposals by Visionary Leaders*, Editors Harlan Cleveland, Hazel Henderson, Inge Kaul, \$10 + \$3

W.F. Hixson

- *It's Your Money*, \$10

William Krehm

- *Towards a Non-Autistic Economy – A Place at the Table for Society*, \$20 + \$6
- *Babel's Tower: The Dynamics of Economic Breakdown*, \$10
- *The Bank of Canada: A Power Unto Itself*, \$5
- *Democracies and Tyrannies of the Caribbean*, second English and third Spanish editions available, \$15 + \$3
- *Meltdown: Money, Debt and the Wealth of Nations* (ed. by W. Krehm) \$25 + \$5
- *Price in a Mixed Economy – Our Record of Disaster*, \$15 + \$3

Kurt Loeb

- *White Man's Burden*, \$15 including P&H

James Gibb Stuart

- *Fantopia*. "With much grace it sets out as a parable the case for monetary reform. A dry-as-dust but terribly vital subject is transformed into a highly readable tale" (W. Krehm), \$8 + \$2
- *Economics of the Green Renaissance*, \$3 + \$2

COMBO OFFERS:

- Special Gibb Stuart Package: *Fantopia* and *Economics of the Green Renaissance*, \$10 + \$2.50
- *Meltdown* plus either *The Bank of Canada* or *It's Your Money*, \$35 + \$3
- *Meltdown*, *Democracies* (English or Spanish), *Price in a Mixed Economy*, *Babel's Tower*, *The Bank of Canada* and *Towards a Non-Autistic Economy – A Place at the Table for Society*, \$90, postage included.

In the industry BHP was known as the more aggressive, with risk-taking geologists who favoured large, complex projects. Rio was seen as stuffy but financially savvy with a tendency to talk down the value of its assets to manage investor expectations.

"As recently as 2001, there were a dozen or more mid-size players with market capitalizations of around \$3 billion to \$5 billion, and many smaller ones. No single company achieved a dominant role.

"Melbourne is very much the world metal mining center. Two decades ago, the city of trams and Victorian-era buildings had scores of mid-size mining houses, including one that became known collectively as the Collins House Group because they were located on a stretch of Collins Street downtown. Rival executives sometimes drank together at the posh Melbourne Club.

"Business changed as the recent commodities boom gathered momentum starting in 2002. New mines were in great demand but they were few and far between. In presentations to investors last year, former BHP Chief Executive Charles 'Chip' Goodyear stated that mining companies were finding only a handful of new deposits in the Western world each year compared with 30 or more in the late 1960s and late 1970s. Most new mines were based on deposits discovered decades before. Many were in places that posed considerable risk or had relatively low-grade minerals.

"Meanwhile resource-rich countries have been tightening the screws on foreign investors. Earlier in Bolivia this year the authorities seized a tin smelter owned by Glencore International AG of Switzerland. Glencore has not been compensated yet. Rio has been in talks with the Indonesian government since 2005 that would clear the way for a large new nickel mine but hasn't sealed a deal."

"New competitors from developing countries are taking form. Russia's united company, Rusal, the product of a three-way merger, elbowed Alcoa aside to become the world's greatest aluminum company. China Shenhua Energy Company, a coal producer, raised nearly \$9 billion in the year's second largest public stock offering. It aims to grow by acquiring assets overseas.

"As BHP and Rio grappled with this new reality, cash from sales in emerging markets were piling up. Both companies' operations in iron ore were booming as highways, factories and apartment towers sprouted up across China. Chinese iron ore demand has more than doubled since 2003, and the country accounts for more than half

the world's iron ore imports. Iron ore prices have more than doubled since in the past three years.

"Mining companies boosted dividends and repurchased shares to appease investors, much as oil companies have done. But that didn't boost future growth prospects. So as big oil did in the 1990s, BHP and its cohorts began buying each other.

"In 2005, BHP launched a \$7 billion takeover of WMC Resources, an Australian copper-nickel and uranium miner and a mainstay of the Melbourne mining scene. Rio bought stakes in other companies' undeveloped mines."

Melbourne Becomes Capital of World Mega-miners

"By 2007, the old mid-size miners had practically disappeared from Melbourne. BHP and Rio, with high-rise offices downtown were the undisputed heavyweights. Globally, the mining landscape was dominated by a handful of giant players, including BHP, Rio, Vale, Xstrata and Anglo American. BHP's market value is now on par with Chevron Corp, Brazil's Vale has a market capitalization bigger than Conoco Phillips.

"BHP and Rio both positioned themselves for bigger deals. When Mr. Goodyear retired from BHP's top job earlier this year, the company chose South-Africa-born Marius Kloppers, who held an MBA and a PhD in materials sciences. Mr. Kloppers had led the team that executed BHP's acquisition of WMC Resources.

"Facing its own CEO vacancy, Rio tapped American Tom Albanese. At age 17, Mr. Albanese had set out from New Jersey to Alaska, persuading the University of Alaska to create a major for him called 'mineral economics.' He got a job staking claims in remote parts of the state, living out of a tent. Mr. Albanese joined Rio Tinto in 1993 and helped lead in the company's efforts to invest in a \$3-billion project in Mongolia, Oyu Tolgoi, that analysts believe is one of the world's largest undeveloped copper and gold deposits.

"As Rio's CEO, Mr. Albanese bought Alcan from under rival Alcoa. Many analysts assumed it was driven in part by a desire to prevent other suitors – including BHP – from launching an attack on Rio.

"In November BHP said it was going after Rio anyway.

"In a presentation laying out the proposal, BHP's Mr. Kloppers said he wanted to create a 'super-major' of mining. The

company would focus on high-reward projects, including capital-intensive jobs smaller companies can't handle. 'I would take my cue from some of the very effective work in the oil and gas sector when some of the super majors were put together,' he said."

Super-corporation size, however, has certain negative social and political costs. When a corporation gets too smashingly big, shouldn't we take time off and concentrate on aspects that may have escaped Mr. Albanese in his meditations in his northern Alaska tent? If such a super-doooper solitary mining champion holds the decision on whether a huge mining project goes forward or not, it should be clear that political power having to do with labour conditions, the environment, moves centre-stage. Would it not make sense to have the national interest retain or acquire a minority position, which could be financed through its central bank when control of that power-center, currently immobilized on the other side of many lines in many sands, returns to the control of elected government.

Issues like that are being addressed in several Latin American countries, Asia, Africa, and Europe. We must start a mega-mining project in the field of historical-central bank research, enquiring how the *Bank of Canada Act* still on our law books but so utterly disregarded, could help us play a key role in the development of our mineral wealth. To an excessively ambitious corporation it may turn out not the most helpful host country where the national interest remains not only undefended, but obviously available for the highest corporate bidder. Mr. Albanese might have taken his model for the sanctity of corporative business from our banks as well as from the world oil biggies.

Once we straighten out matters between the Bank of Canada and the *Bank of Canada Act*, we will have much more to offer super-big resource corporations, as well as smaller ones. Since years of expensive slugging will be necessary to prepare large projects for production, with the government a reasonable and fair minority partner in the projects, but ever alert to the national interest, it could provide its guarantee to make possible the financing of all or part of the mining infrastructure through the Bank of Canada. This is possible through a guarantee of the Government of Canada, which under section 18(c) of the *Bank of Canada Act*, would allow the Bank of Canada to finance part of such costs against government guarantee. That could be of tremendous help both to the mining behemoth especially when

money gets tight and the project is still not bringing in income. This would not only make the Government of Canada a more helpful partner for the mining corporation, but virtually all the interest costs of the corporation would end up as dividends to the Bank of Canada's one shareholder – the same Government of Canada. Such money would not only be of great importance to

the country – above all during a recession – but of immense help in sealing an advantageous relationship between the government and the corporation. Those funds could be used in part to provide adequate living and safety conditions for the mine workers. It would bring our national planning back to the realities of the real economy.

William Krehm

The Cost of Spin-Doctoring for Our Banks is Rising

This article first appeared in ER in August 1998 and was carried in Meltdown Volume 1. We have condensed it slightly for reasons of space.

Time was when critics like COMER were simply treated as unmentionable. Now that seems to be changing. In the May-June issue of *The Canadian Banker*, Harvey Schachter's article "The Great Debate" refers to our submission to the Task Force on the Canadian Financial Services in his very first paragraph. But the purpose of that reference was hardly to inform his readers of the content of what we had written. Instead, by juxtaposing our submission with the Saskatchewan Federation of Labour's use of the occasion "to sing some anti-bank songs by the Wobblies (Industrial Workers of the World)," there was an artful attempt to present us as unfriendly to banking in a far-out way. Our submission, however, could better be described as an effort to lure the banks back to banking.

Google to the Rescue

I was represented as "expounding on the waning fungibility of money and [my] other economic theories." In actual fact there is nothing esoteric about "fungibility." It occurred to me to look up the word "fungibility" through Google. And not only was I not mentioned as its author, but I needed only type a half dozen words for the references to various dictionaries started dropping down on my head as cans of peas might on the head of a grocer who has inadvertently tipped a shelf. We are left stunned how a person of such ignorant cheek as Mr. Schachter should have been chosen to direct or sum up the facts in a matter of such consequence.

But let me proceed with the Google quotes: Fungible – definition from Dictionary.com: "Commodities, options and securities are fungible assets. For example,

an investor's shares of Xerox left in custody at a brokerage firm are freely mixed.

Wikipedia, the free encyclopedia: "Fungibility is different from liquidity. A good is liquid or (tradable) if it can be exchanged for money or another different good."

That is entirely another matter from the subject of the alleged enquiry. The next one fits better with what concerns us. That is the broad definition: "Fungible definition-interchangeable. The term is often used to apply to financial instruments which are identified in specifications" (www.investorwords.com/2132/fungible.html).

Our submission to the Task force dealt with the money supply and hence it deals with everything that is priced and traded within the boundaries of a nation. For the currency of a nation is one of the key depositories of its sovereignty, exercised largely through the taxing power and control of the currency.

It is precisely such irresponsible manipulations that got our banks into their present problems – through the deregulation of banking to allow its spread into functions previously ruled incompatible with banking – stock brokerages, insurance and mortgage finance.

"Fungibility acquired key importance when the Discussion Paper of the Task Force was published. That was because the junk bonds of Thailand, Malaysia, Indonesia and South Korea, carried high interest rates and were often denominated in US currency. As a result the ability of the government issuing such securities was questionable.

"None of this was so much as mentioned in the Task Force's Discussion Paper, although it was a no private concern of mine. Yet it does make a difference whether our Canadian banks keep reserves payable in Canadian legal tender – as they had until 1994 – or in fancy Indonesian bonds."

"Nor does the importance of the fungi-

bility concept end there. It is becoming recognized that our key growth statistic – the Gross Domestic Product (GDP) – measures the well-being of the economy by lumping together the additional spending to cope with disasters such as oil spills, earthquakes, the rape of the environment, divorces, crime, epidemics with activities that do contribute to society's well-being. Indeed, proposals for replacing the GDP with a statistic put together with more fungible components. Remarkable that this should not have reached the ears of the CBA's scholars.

"The same goes 'for my other economic theories.' Though flattered at the suggestion that the notion of money creation is an invention of mine, I must decline the compliment. Most of COMER's submissions to the Task Force concerned money creation which with the phasing-out of the reserve requirement in 1991-3 in Canada, has become a near-monopoly of our banks and other financial institutions. Though the banks and the Governor of the Bank of Canada deny that money creation even exists, we can cite an impeccable witness to the contrary.

"In 1945 the Canadian Bankers' Association – the proprietor of *The Canadian Banker* – published *A Background of Banking Theory* by W.T.G. Hackett, economist of the Bank of Montreal, that stated: 'When the government borrows by selling securities to the central bank there is made possible an expansion of chartered bank deposits equivalent to about ten times the value of the bonds thus sold, which would bring about an approximately tenfold addition to the money supply' (p. 54). The ending of the requirement that the banks put up non-interest-bearing securities with the BoC in 1993 pushed the multiplier up from 10 to about 70. Currently the ratio of our banks assets: liabilities to the legal tender they hold is 317:1. With deregulation the quality of those assets has declined greatly to include bonds of South Korea, Indonesia, and fancy derivatives."

On the Fungibility of Street Walker Services

That is how we entered the Sub-prime Age. It embraces not only bonds and other debt, but street-walkers, journalists and economists. As the demand for certain services soars, the fungibility of these services tends to decline. We can only assume that *The Canadian Banker* is not ungenerous with writers and scholars prepared to impart an amiable twist to certain crucial facts.

William Krehm

Banks' Margins Shriveled

The Wall Street Journal (9/01, "Banks' Narrowing Margins" by Dana Cimilluca) informs us that our banks, having been hit by just about everything else, are now troubled by the declining returns on their plain banking operations. As though the sub-prime mortgage crisis were not humiliation enough! Yet that should have come as no surprise. By aggressive activities over some decades both on the political and the marketing fronts, they have long since taken over those "other financial pillars that had been forbidden them, as the means of making the economies of most of the world whole once again – with no small contribution, of course from the Second World War, and an immense rethinking of economic theory.

With all that behind them they went on to turn the clock back to where it had been left by the Wall Street crash of 1929. And all that had been learned from the deepest Depression and bloodiest war experienced up to then was forgotten. A new crop of PhDs of Unlearning took over our central banks and our economic faculties and our financial institutions.

And deadly new technologies for war and high finance were brought in to guide the US as dominant world power. These borrowed the rhythms of nuclear weaponry for the conquest of the world economy. Last month we reported on the humiliation that overtook a couple of the largest American banks when they had to sell substantial capital participation in two large banks to government sovereign corporations in an Arab oil state and in Singapore. This month the tidings are hardly better. They report that the returns banks are enjoying from their plain banking operations are down.

Obviously that is not going to change in a great hurry. Too much that had been learned at enormous cost over decades has been buried. Our bureaucrats, who have long since forgotten what it is to operate with an open mind, would have to learn again everything that two successive generations of bankers had learned during the Depression, the world war, and thirty years of peace. University economics faculties have been swept clean of the most productive generation of economists ever developed.

The "financial engineering" that they laid claim to had more to do with unbounded appetites than with serious mathematics.

Repeatedly COMER had warned that

globalized and deregulated banking would devour all reserves that the unglobalized and regulated banking system throughout world had offered. Moreover, pooling the national markets and the option system of high executive rewards combined imposes on the world economy a dangerous forward lean. More and more that leaves little escape from the self-imposed tightening world market than to face a disturbing decline of returns in any part of the world from plain banking. That this should have been imposed by an economic dogma of a self-balancing market indicates the extent of the world's troubles.

We witnessed something similar when the Savings and Loans were taken over by the US banks with disastrous results. To cope with that in the latter 1980s, the spread between the interest the Canadian banks paid the bank's depositors and what they charged borrowers grew outlandishly. We seem to be headed into another such period, that will not improve the reputation of our major banks. Of these several have settled out of court with US authorities for having participated and even designed some of the Enron off-the-books scams.

"The average interest margin between what the banks charge their customers and pay on loans to them averaged during the third quarter 3.78%, the lowest level since 1991, according to SNL Financial, a Charlottesville, Virginia, research firm. Small banks may rely on such loan business for as much as 80% of their income. While larger banks may be able to depend on investment banking to make up the difference in interest rate margins.

"Anecdotal evidence holds that competition has kept deposit costs high,' said the report issued by banking analysts John McDonald and Kenneth Usdin. They also noted that as some rates fall, customers move to toward higher-yielding products. The bank attributed the decline to a combination of weakening credit quality that deprives banks of interest income from assets they have to keep funding, lower interest rates, that make lending less lucrative and 'seasonal changes in deposit composition.' The real problem now is that banks have got to keep the lid on or reduce the cost of these deposits, says Jeff Brown, a principal at Deloitte Consulting LLP in Charlotte Consulting LLP in Charlotte, NC."

W.K.

Has France, Too, Climbed Aboard the Fast Express to Hell?

The New York Times (28/01, “A French Style of Capitalism Is Now Stained” by Nelson D. Schwartz and Jad Mouawad) tells a melancholy tale: “Paris – In a country where the hurly-burly of market capitalism has long been viewed with suspicion, Société Générale was a rare Gallic success story – the Chanel of French banking. The bank pioneered some of the most complex instruments in international finance, earning billions of dollars and the grudging respect of American and British rivals.

“So it was a shock to their national pride when top executives of Société Générale found themselves on the seventh floor of the company’s ultramodern headquarters a week ago Saturday interrogating a 31-year-old trader named Jerome Kerviel and discovering what their innovations had wrought.

“Mr. Kerviel acknowledged placing more than \$70 billion in secret, unauthorized derivatives, according to Société Générale, saddling the bank with a \$7.2 billion loss, the biggest ever caused by a rogue trader.

“Now the bank, and the broader world of French business, finds itself shamed in the very arena where it had taken pride in being one step ahead of its Anglo-Saxon rivals that dominate financial niches like investment banking and securities underwriting.

“Even worse, Mr. Kerviel took advantage of the very technological sophistication for which the French are known to hide his tracks.

“‘I have to admit this is a massive shock for us,’ said Jean-Pierre Mustier, who as a 26-year-old helped midwife equity derivatives trading in Société Générale in 1987 and is now one of the bank’s top executives as head of the bank’s corporative and investment banking division.

“It was only last May that Christian Noyer, the governor of the Banque de France, the nation’s central bank, promoted the country’s competitive edge in equity derivatives, an arcane universe that allows investors to take risky bets on future moves of stocks or markets. With a 25% global market share, M. Noyer boasted at a banking conference at Mumbai, ‘French expertise in this field is founded on solid teaching in maths, the key to excellence in financial fields, and on an important hive of university-level talents.’”

Against that we must pit the view of John Maynard Keynes not too long before his death in 1946, in questioning econometrics, that tries to deduce what statistics will be saying in the future from what they said in the past. Keynes simply referred to the drastic change produced by the new patterns in economic theory itself. And, of course, since Keynes’s death, the banks have become deregulated and globalized to the point where they have achieved a degree of power that no other group in society can match. This being so, not only econometrics but derivative constructs that mimic the exponential mathematical patterns of the atomic bomb for obligatory ever accelerating growth roil the environment, and reshuffle human relations to an unforeseeable extent. How could this be determined in advance and subjected to risk management? Above all when through the other side of their mouths the officially inspired posit a self-balancing market on which the mathematics of the alleged risk management are based. That it should have caught up with and taken over the lively development among French economists that was taking place in France a few decades ago can be illustrated by my own experiences there at the time. Let me quote from my book *Price in a Mixed Economy – Our Record of Disaster* (Toronto, 1975, Chapter Four, entitled “The French School of Economics”).

Enter Marginal Utility

France was one of the three countries where the theory of marginal utility value theory arose almost simultaneously: France, Britain, and Austria. Adam Smith had used a labour theory as one of his several theories of value to understand the evolving economy of the immediately pre-industrial age. In Britain several decades later David Ricardo had used the labour theory of value to make the case for bringing down the tariffs that buttressed the privileged position of the large landowners, Karl Marx used such a value theory to emphasize the exploitation of labour by the industrial capitalists. John Stuart Mill, whom Marx considered one of the more superficial 19th century economists, actually developed a model that has much appeal to us today – its goal was a “steady state” rather than constant indus-

trial expansion, and included the proper development of humans and care for the environment as an essential part of his goal.

After the barricades that were thrown up across Europe in 1848, the class-warfare had become so menacing that a deep need was felt by those in charge of society for a value theory that would shift the locus of theorizing from the “satanic mills” of the raw industry of the day to the subjective pleasure of the ultimate consumers of the products produced. All this was done with an intimidating use of calculus for those who mistook its use as a guarantee of scientific validity per se. But nothing can be deduced *from* mathematics.

What is brilliantly possible is to deduce relationships implicit in empirical data *by* mathematics. Thus utilizing the astronomical observations by Tycho Brahe, John Kepler found that the planets moved in closed orbits, and from that Isaac Newton, applying the binomial theorem he had developed, invented infinitesimal calculus that made it possible for him to discover the law of gravity. However for the marginalist economists the latter 19th century to go on to deduce not *by* calculus but *from* calculus that the market was self-balancing made no sense to anybody with the slightest notion of what mathematics can and cannot do.

Because of the realization of this by many French economists after World War II France was a very creative place.

France Becomes Happy Valley of Economic Thinking

I had by then after a wide-ranging journalist experience in Latin America, and what university training I had had in mathematics, plus some business experience, reached the conclusion that the notion of a self-balancing market was unsupportable. I embodied this in a sixty-page essay and sent it to some thirty economic publications throughout the world. It was published in what was then the leading French economic journal in France, *La Revue Économique*. That opened a world to me that simply had no equivalent in the English-speaking countries. Thus François Perroux, one of the many French economists who questioned the notion of a self-balancing market, wrote of Leon Walras, the French discoverer of the self-balancing market: “It is impossible to speak of a ‘psychology’ of maximization; one can only talk of a rule of maximization of economic life as we are able to observe it, rather it is the polar opposite. At no time in the history of the Western peoples has there

been a tendency to eliminate the elements of private power in merchant economy; nor a tendency toward the sovereignty on all markets of price determined by anonymous forces arising in equal measures from the contributions of all participants. General equilibrium is a gymnastic exercise of the mind that reduces the action of people to mechanically organized forces. It is the product of a combination of simple mathematics, distorted observations, and – unconsciously without doubt – an apologetic attitude.”

Another French economist of the period, Jean Marchal had written: “In reality the distribution of the national revenue takes place through two series of activities that we shall designate ‘within the structure’ and ‘action upon the structure.’” And that in turn is closely linked to Perroux’s concept of the “dominant revenue”: “In turn the dominant revenue has been that of the landowners, then industrial profit, then financial and industrial profits in a mixed economy, in which the rate and mass of profit are functions of a complex combination of public and private, of market and extra-market actions.

“During a specific period of development, the dominant revenue is that one to which the others adapt themselves. In an apologetic doctrine, it is represented as the revenue that, by the rate and mass which it achieves, determines whether the given economy functions properly. In the institutional framework corresponding to the given dominant revenue, that in fact is the case, but in another context it would be otherwise.”

Perroux’s Dominant Revenue

“This brings us to the very threshold of the subject of this book. Conventional economic theory is the story of our economy told in terms of the profit of the dominant revenue. Even the revenues of the other factors of production have been revamped and denatured to the idealized logic of the profit motive and presented in marginalist form.

“Jean Marchal views price behaviour from this angle: ‘Price rise has become an integral part of the mechanism of distribution in our modern economy. Today an increase in the monetary revenue of any group does not bring with it a compensating reduction in the revenue of other groups, but a parallel increase.’

“One of the ‘paradoxes’ that have haunted economic reporting in the past decade is the recurrent combination of rising prices and

mounting unemployment. By the ground rules of equilibrium theory industrial slack must bring with it declining prices, whereas rising prices are associated with the upward phase of the cycle. Yet this supposed paradox has not been without precedent.... It was observed and documented for several European countries by J.P. Mockers: ‘If this cannot be taken as an absolute general rule, we must, however, state that in most cases observed, the years of economic slack correspond to periods when price increases have been most marked.’

“In some respects French economists have been a decade or two ahead of their English-language colleagues in handling the problem of inflation. As early as 1862 Pierre Biacabe discussed the new structural aspects of price rise as follows: ‘It is necessary either to adopt a new definition of inflation, or to use the term only in its original sense and to find another terminology for the new phenomenon that we are trying to track down. But no one has as yet detected this new phenomenon, and that is because we have no valid theory to grasp the contemporary economic system. Thus we go on calling ‘inflation’ a phenomenon that no longer has the same form, the same object, or the same function as formerly. We continue viewing it as a sinister thing, harmful and destructive, because of the effects it may have had in a previous economic system’ (Analyses contemporaines de l’inflation, Paris, Sirey, 1962, p. 222).”

It was only on reading this that I understood why my 60-page essay, in which I had identified the new structural factor that created the phenomenon of what I called “structural price rise,” had been accepted and published by the leading economic journal in France at the time *La Revue Économique* in their issue of May, 1970. I had quite independently developed the concept that Biacabe had written about 13 years earlier, and identified the missing factor they were seeking.

Unfortunately, today little remains of either the journal or that school of economists. The work of Perroux is next to forgotten. University faculties have been cleansed of all who question that equilibrium theory and misplaced mathematics have made way brutally, and with disastrous results, in the relationship of cultures and nations.

As the world is global and spins incessantly, globalization and deregulation and endless expansion has not only constant perils but dangerous certainties. John Maynard Keynes pointed out the contradiction

of a discipline that assumes constant accelerating expansion in a limited space to seek in the statistics of the past a mirror that would provide a picture of the future. As early as May 1993, writing in *Economic Reform* (April 1992), I noted the ascent of “risk management” supposedly achieved by derivatives: “These abstract mathematical instruments purporting to cut up and quantify the degree of risk – oddly enough guided to a larger extent by the statistics of a more stable, simpler, and less globalized and deregulated world, can hardly provide us with the answers of our ever more expanding, globalizing future.” But our obsession with risk management is based on the extent to which we have exposed ourselves to ever greater and omnipresent risk rather than our achievement of convincing methods of managing it. That is why “bankers’ exits” – the banker who puts the “risk management” parcels together seeks to unload them at a profit at the earliest possible moment.

But the magic lure of derivatives – in essence the tug of the exponential curve which is the mathematics of the atomic bomb in such a setting, is irresistible. It is the absolute assurance of ever accelerating growth, which holds the promise mistaken for assurance of mounting profits and options of increasing worth for deserving executives. And this supposed means of predicting the future and its risks is based on past statistics in a world where constant growth and speed up is the basis of the alleged certainties of derivatives.

A Misleading Guide to the Future

John Maynard Keynes made the important distinction between the laws of natural science – physics and chemistry, for example, can be trusted to remain the same, whereas the very Deregulation and Globalization and mandatory speed up in an already overburdened environment change the laws of the environment in which our economies operate at an ever dizzier clip.

Nevertheless just a couple of years ago at a plenary session of a Conference on Heterodox Economics at Cambridge, Keynes’s university, I was unable to extract from three experts on derivatives an answer to my question whether they are for the regulation of the use of derivatives. And yet all three leaders of the discussion were critics of derivatives, and from one of them, J. Kregel, by then in the service of the United Nations, I owed much of my early introduction to the black art of derivatives.

William Krehm

Corporations Turn Cannibal

As Adam Smith told the tale, it was almost a courtly minuet. However, as each latterly chapter unfolds under our incredulous eyes the dancers strip off decorum to become cannibals, sinking tooth into flesh of their own kind.

The New York Times (16/01, "Citigroup's Big Loss Fuels Anxiety and Depresses Stocks" by Jenny Anderson and Eric Dash) seemed to relish the details: "Citigroup, the nation's largest bank, reported a staggering fourth quarter loss of \$9.83 billion on Tuesday and issued a sobering forecast that the housing market and the broader economy still had not bottomed out.

"To shore up their financial condition Citigroup and Merrill Lynch, rocked by the subprime mortgage debacle, were forced to go hand in hand for cash infusions from investors in the US, Asia, and the Middle East, for a total of nearly \$19.1 billion.

"Citigroup's gloomy news added to the anxiety that the mortgage crisis could plunge the economy into a recession. Compounding anxieties, the government reported that retail sales in December declined for the first time since 2002.

"Growing pessimism led to another sharp sell-off in stocks, which fell about 2 percent for the day and are now down about 6% since the beginning of 2008, the third worst start for a year since 1926."

Forgetting the Lessons Learned from the Depression and World War II

That becomes particularly disquieting, since our government has suppressed just about every thing that we learned in Depression, war and in the postwar at a staggering human cost. Since the memory of all that has been wiped clean, we are ill-prepared today to confront a more entrenched version of the same highly profitable dogmas of our enthroned financial sector.

"More bad news is coming, with Merrill Lynch expected to report sizable losses this week and major financial institutions like Bank of America retreating from their investment banking business. These moves add to concerns that financial institutions will be forced to pull back from lending at a time the economy most needs access to credit to help cushion it against a downturn.

"The only other time this happened in the last 100 years – financial firms going

from making good profits to negative profits – was the Depression in the 1930s,' said Richard Sylla, a professor of financial history at New York University. 'I don't think it will be as bad this time. The Federal Reserve is fighting the problem as hard as it can.'

"Just last week, the Federal Reserve chairman, Ben S. Bernanke, said the economy was worsening, bringing widespread hope the Fed would move swiftly to lower interest rates. Wall St.'s worsening results combined with Mr. Bernanke's comments will certainly add fuel to the economic stimulus package being debated by the White House, Congress and the central bank.

"Citicorp's record was caused by write-downs from soured mortgage-related securities and reserves for current and future bad loans totaling \$23.2 billion. Responding to a string of dismal quarters, the banks said it would also lay off another 4,000 workers, on top of announced reductions of 17,000 employees to conserve \$4.4 billion in cash annually."

Wall Street Goes to Asia Cap in Hand

"Citicorp, which earlier had raised \$7.5 billion from the Abu Dhabi Investment Authority to improve its capital. Other foreign or unusual sources of new capital was the Government of Singapore Investments Authority, the Korean Investment and Citigroup's former chairman, Sanford I. Weill. Citicorp will also offer investors about 2 billion dollars of newly issued debt securities, a portion of which will be convertible into stock.

"At the same time Merrill Lynch announced that it had issued \$6.6 billion in preferred stock to the Kuwait Investment Authority, the Korean Investment Corporation, Mizhuo Financial Group, a Japanese banks and other investors, including the New Jersey Pension Fund and a Saudi Investment Fund. That is in addition to the \$4.4 billion it raised in December from Temasek Holdings of Singapore.

"While the banks were able to raise record amounts of cash, they had to circle the globe to get it in two separate rounds.

"There is a tremendous of liquidity in the world,' Mr. Weill said in an interview.

"Citigroup which has a large consumer lending business, sounded some warning bells on Tuesday that the American economy was turning. The bank reported sharp

upticks in losses stemming from souring auto, home and credit card loans. with losses coming from the same areas being hit by real estate.

"Two-thirds of the credit card losses, for example, occurred in just five states – California, Florida, Illinois Arizona and Michigan – that have been among those hit hardest by the housing downturn. Garry I. Crittenden, the company's chief Financial Officer, acknowledged the bank's losses seemed to be accelerating month after month.

"Citigroup executives expect house prices throughout the country will persist, dropping on average another 6.5 percent to 7 percent.

"The news sent the company's stock tumbling 7.3 percent, to \$26.94. It has now fallen about 50% in the past year. The fear is that financial institutions will continue to take large write-downs as bad loans mount, while consumers, facing higher energy costs, falling house prices and a bleak outlook for job growth, will rein in spending even more than they already have."

Saying "Yes" but at No Altar

However, a highly entrepreneurial assortment of corporations do their harvesting in other folks' cemeteries. *The Wall Street Journal* (17/01, "Financiers Reap Riches Even as Deals Wobble" by Liam Pleven and Suzanne Craig) explain the play: "To understand a root cause of the financial crisis shaking global markets, take a look at Kevin Schmidt's pay-check.

"Mr. Schmidt arranges mortgages in Shreveport, LA. He earns his money up

COMER Videos \$10 each

On economic theory:
Towards a Mixed Economy

On money creation:
The Creation of Money and its Consequence

2004 COMER Conference:

Video 1:

William Krehm, Bill Fisher,
Richard Priestman,
Allistair McConnachie

Video 2:

Connie Fogal, Paul Hellyer

For more information visit our
website at www.comer.org

front, taking a percentage of each loan once papers are signed. 'We don't get paid unless we can say "Yes" to loans,' his firm's Website says.

"The problem, which Mr. Schmidt says he sees clearly: brokers have little incentive to say 'No' to someone seeking a loan. If a borrower defaults several months later – as Americans increasingly are doing – it's someone else's problem.

"At every level of the financial system, key players – from deal-makers on Wall St. and in the City of London to local brokers like Mr. Schmidt – often get a cut of what a transaction is supposed to be worth when first structured, not when it actually delivers in the long term. Now, as the bond market wobbles, takeover deals unravel and mortgages sour, the situation is spurring a reexamination of how financiers get paid and whether the incentives the pay structure creates need to be modified. This week Congress asked three prominent executives to testify about their pay packages.

"Up-front commissions and fees are well established on Wall Street. Investment banks get paid when billion-dollar deals are inked. Firms that create complex new securities are paid a percentage off the top. Rating services assess the risk of a new bond in return for fees on the front end."

On that John Thain, until a few months

ago head of the New York Stock Exchange has some penetrating reflections (*The Wall Street Journal*, 18/01, "Merrill's Risk Manager" by Suzanne Craig and Randall Smith). Said Mr. Thain: "The growth prospects outside the US are actually better than in the US. and there is no reason why we can't do it profitably."

WSJ: "What shocked you the most?"

"Mr. Thain: 'Two things. One was the lack of understanding of risk in these positions and the other was the lack of balance-sheet control. The balance sheet really got out of control and traders were able to put on positions that were way too big. And I don't [think] there was a good understanding of mortgage markets in general, and I don't think there was a good understanding of what the risk was.'"

From other articles on the same front page of the Money and Investing section of the same issue of the *WSJ*, we get to some crucial points. In a risk-ridden business, risk management came to be increasingly farmed out, as might the engineering of a production plant. But with the rapid growth of the mortgage business in all its aspects, this added ever more outside services, quite apart from the foggy if consoling reassurances that economic theory had been reduced to be the beginning of the 20th century. The end result was a well-paid commitment that the

risk evaluation, and/or insurance against risk had been provided, and that covered the backs of the high executives. In relative "normal" times this filled the bill and the reliability of risk insurance. In earlier times, the insurance coverage was never seriously put to the test.

Mortgage Lending Based on Pure Faith

The assessment of the risk that is supposed to go with any insurance policy seemed to be there, as was documented by the paid invoice of the risk insurance agent. However, too much of the checking began to be farmed out including some of the more questionable credit evaluations of the subprime mortgagors. Relegating all that stuff to off-balance sheet files seemed an efficiency until it was proved to be fraud. But at the very first serious test that was proved not to have been the case.

What the rich data on this aspect of the subprime mortgage crisis in our media and parliament has still not caught with is the connection with what happened a century or more ago in the gelding of economic theory and essentially a continuation of the same technique that has brought us the subprime mortgage crisis, and its further consequences that are still pouring in.

William Krehm

Completing the Moral of the Record

The Wall Street Journal (30/01, "FBI Probes 14 Companies Over Subprime Turmoil" by Even Perez and Kara Scarrell) informs us from Washington: "The Federal Bureau of Investigation has opened criminal inquiries into 14 companies as part of a wide-ranging investigation of the subprime mortgage crisis, FBI officials said. The probe is focusing on accounting fraud, securitization of loans and insider trading, among other areas.

"The FBI wouldn't identify the companies under investigation, but said in general that the bureau is looking into allegations of fraud in various stages of the mortgage process, from companies that bundled the loans into securities. to the banks that ended up holding them.

"Federal prosecutors in Brooklyn, NY, and the Securities Exchange Commission have already been looking into the collapse of two Bear Stearns Cos. hedge funds. The two authorities are also investigating

insider stock sales and accounting of New Century Financial Corp., a mortgage lender in bankruptcy proceedings. The New York state attorney, Andrew Cuomo, is looking into possible wrongdoing connected with mortgage-backed securities bought and sold by Wall St. firms.

"The FBI's investigations represent an added dimension to the bureau's decade-long focus on mortgage fraud which spiked during the housing boom. For years, the FBI has targeted fraud involving real-estate agents, appraisers and fake buyers. Now the FBI is taking a closer look at possible fraud in the secondary market for mortgages, which could implicate better-known financial firms. The faltering US housing-market and a rise in defaults and foreclosures, particularly among low-end borrowers, has whipsawed global stock and bond markets, led to the dismissal of Wall St. chiefs and resulted in losses by banks, hedge funds and securities firms.

"Neil Power, chief of the FBI's economic crimes unit in Washington, said the bureau was going over the books of insider-trading or other wrongdoing. FBI officials say the Bureau is working with the SEC, which has opened more than three dozen investigations in the mortgage business, including the role of mortgage brokers, investment banks and due-diligence firms involved in the underwriting and securitization of credit-rating firms that rated mortgage-backed debt. In recent weeks, the SEC has sent subpoenas to some firms involved in the underwriting and securitization process, people familiar with the matter say.

"FBI officials say the bureau has 1,200 mortgage-fraud cases under investigation. They believe many more are in the offing, based on the number of suspicious activity reports filed by banks. The number of suspicious activity reports grew from 35,000 in 2000 and is projected to reach 60,000 in 2008, the bureau says."■

The Economic Topography is Changing Beneath Us

The economic topography is shifting around us. The old clichés about licking inflation and all will be well are still heard from time to time, but nobody seems to take them seriously any more. For something deeply baffling is taking over and shifting from industry to industry, over oceans and across continents.

It began with subprime debt and the realization that risk management upon which the world was being restructured was clearly not working because it had undermined our subprime mortgages. In these collateral debt had in fact replaced clear obligations to deliver *legal tender* when due. And now it was hopping across continents and oceans. The collateral debt obligations backing the debt was no longer in legal tender, currency of the land, but instead in an artificial array of bits and parts of collateralized debt. And the obligations can change. After a year or two and when that takes place in a world where for decades now the mortgagors on the hook for keeping in good standing all the bits and pieces of the mortgages which might be diced and attached to other mortgages backed by different securities of different degree of risk and allotted to yet other creditors.

Enter Subprime Credit Card Debt

And games with derivatives and other fancy toys are no longer confined to mortgages; they are turning up with all sorts of debt. Thus *The Wall Street Journal* (1/14, "High-End Cards Fall from Grace" by Robin Sidel and David Enrich) informs us that these new structured collateral debt obligations have taken over the upper reaches of the credit card business. Calling it "collateralized debt obligations" is an evasion, just as calling syphilis "structured collateralized sex" would be. There is a misleading sense of fake security about both. But let us hear what the *WSJ* has to say on the subject: "The luster on all those silver, gold and platinum credit cards is getting tarnished. For the past few years banks that issue credit cards have aggressively wooed affluent customers with lavish perks and fat credit lines. Now, that high-end strategy is coming back to bite the banks. There are growing signs that some of these consumers are having a hard time paying their bills.

"It is the latest in a series of woes for US financial institutions, struggling to contain a growing variety of credit-related problems after years of strong profits. Banks have lost billions of dollars from soured home loans and mortgage-related investments. And defaults in commercial and industrial loans could rise later this year if the economy weakens further.

"Investors and analysts will get an in-depth look at the credit-card problem this week when Citigroup Inc. and J.P. Morgan Chase & Co. – two of the biggest issuers of plastic – report fourth quarter results. Both are expected to set aside hundreds of millions of dollars to cover consumer loans.

Cleveland Subprime Mortgage Capital of the Land

The Globe and Mail (1/19, "2 million foreclosures \$100 billion in losses" by Paul Waldie) reports: "When Sam Robertson took out a second mortgage on his home in suburban Cleveland three years ago, he couldn't believe how easy it was. The interest rate seemed low, the approval process quick, and soon he had a \$61,000 (US) loan backed by a house worth \$100,000. Then Mr. Robertson, 55, lost his job with a plastic-bag company. He found temporary work, but he got behind on payments just as the interest rate on his mortgage reset at a higher level. The house his family had lived in for 27 years is in foreclosure.

"Versions of Mr. Robertson's story are being played out across Cleveland, which has become the epicentre of the housing problems plaguing the US and across our border. The foreclosures in Cleveland have soared from less than 300 in 2003 to 7,583 in 2007, one of the highest rates in the US.

"The defaults have depressed property values, cut local tax revenue and left many streets lined with vacant buildings. Most have been stripped of windows, doors, siding and even copper wiring and pipes.

"Over the next two years, 1.8 million subprime mortgages, these aimed at riskier borrowers, are expected to reset at higher interest rates. It is expected that 1.2 million of the loans will go on to foreclosure. Those that don't default will barely get by after making their payments.

"Mortgage woes and falling house prices

es have prompted consumers to cut their spending to a five-year low. Banks and other institutions that pumped out more than \$2.5 trillion of subprime loans between 2000 and 2007 have taken massive losses. This week two of the biggest, Merrill Lynch and Citigroup reported a combined loss of \$20 billion for the fourth quarter. In total, banks in Canada have piled up more than \$100 billion in housing market losses. Throw in higher energy costs, weak unemployment and lower stock prices, and it's no wonder that many economists predict that the US could fall into recession this year. And that means a slowdown for Canada as well.

"Subprime loans don't exist in Canada, but they have been around in the US for decades. They were initially intended to help wealthy people buy second properties, but as the housing market soared, they morphed into a vehicle for riskier borrowers to obtain a mortgage. Many subprime loans in Cleveland started at 8% and increased to 11%. Borrowers were often told not to worry because they could always refinance later, because their house would be worth more by then.

"To fund borrowers, mortgage companies sold their subprimes to big banks. The banks then packaged them up as securities and sold them on the stock market around the world. Investors snapped them up, convinced that the securities were backed by the booming US housing market. From 2000 to 2006, the number of subprime loans increased from 911,360 to 3.2 million, according to a study by the Center for Responsible Lending."

US Mortgage Subprimes on a World Tour

"To feed bank demand mortgage companies offered higher commissions to brokers who steered clients into subprime loans, which prompted some to loans with few if any background checks. Some loans required borrowers to show little more than pride of ownership.

"Mortgage brokers and lenders became little more than aggressive salesmen, even going door to door in some neighborhoods. In some neighborhoods in Cleveland brokers would show up with lists of purported building code violations and coax owners into taking out loans to fix the problems. One woman in a poor Cleveland neighborhood ended up with a \$70,000 loan convinced that her garage needed repairs. Some brokers worked with corrupt build-

ing inspectors. Later if such financing were arranged to do the prescribed repairs, the mortgage broker would split the fee.”

Much of the paper-work was “outsourced.” It was enough to have a mortgage risk appraiser insure the soundness of the loan. In the old days such insurance was rarely if ever called upon to cover a claim. But that was in a world of rising property values, and in which some serious concern and responsibility were sere shown by the insurer. There is no room for that in the current frantic universe of spliced and diced and prepackaged risks. In this world, a new ethic has taken over – the originators of the mortgage consider their work done and their commission earned up front, and it is enough for them to have provided an insurer of recognized trustworthiness to vouch for the soundness of the mortgage and the mortgagor.

In the light of that an item in *The New York Times* (19/01, “Two Bond Insurers End the Week Severely Weakened” by Vikas Bajaj) had the resonance of a knell in its implications for the subprime debt crisis: “It was a terrible week for Wall Street, and a devastating one for companies that promise to protect investors against bond losses. Already under siege for having branched into risky mortgage-related debt from far safer municipal bonds, two bond guarantors – who have insured hundreds of billions of dollars of debt – ended the week in severely weakened conditions.”

Insurance in Need of Insurers

“One insurer, Ambac Assurance, which dropped nearly three-fourths of its stock market value in the first four days of the week, lost its most coveted asset on Friday – the AAA credit rating that has allowed its guarantee to vouch for lower-rated bonds. The company has guaranteed \$556.9 billions in bonds, and about \$66.9 billion of the amount is issued by collateralized debt obligations that have under scrutiny in recent months. Altogether, bond guarantors have written nearly \$3.3 trillion in insurance.”

Thus one thing leads to another in this strange world of collateralized debt, but these are no daisy chains. They drag you mercilessly to the world where everything is supposed to be determined by consumer supply and demand, and no serious double entry accountancy is allowed to interfere with the power privileges of those in charge of the system.

W.K.

The Art of Banking in India

The Wall Street Journal (08/01, “In the Shadows of India’s Loan Boom” by Tariq Engineer) writes of strange aspects assumed by India’s banking boom. These are at quite the opposite pole from the humane concerns of the micro-banking that received so much attention a few years ago.

“Vinod Kumar was sitting in a friend’s car listening to the radio one evening last January when a stranger appeared, yanked him from the vehicle and beat him with an iron bar. While the 21-year-old college student lay bleeding in the parking lot, the assailant sped off with the tiny silver hatchback. But this was no ordinary mugging. Mr. Kumar’s attacker was a *goonda* – a thug – working on behalf of one of India’s largest banks.

“Incidents like the one that left Mr. Kumar with 12 stitches in his scalp and a 10-day hospital stay reflect a dark side of India’s economic boom. As consumer lending soars to record levels, India’s banks face mounting criticism and government sanctions for their aggressive loan recovery tactics, which sometimes include using hired thugs. With the economy growing at more than 8.5% a year for the past four years. Indians are taking on home, car and credit car debt as never before. Retail loans have almost tripled over the past three years. According to the Reserve Bank of India, or RBI, they reached \$124 billion for the fiscal year ended March 31, 2007.

“That has created new headaches for Indian banks, which have limited experience recovering loans from defaulting borrowers. Traditionally most Indians have avoided debt. Even now only 30 million credit cards have been issued nationwide, an exceedingly small number for a nation of over a billion people. In another recent case, an HDFC Bank manager and two recovery agents were charged with criminal intimidation, extortion ‘outraging modesty’ of a woman in Mumbai. The customer claimed to have already paid back the loan, while his wife said that the agents had ‘misbehaved’ with her. The manager still works for the bank, that declined to comment.

“Ruling on Mr. Kumar’s case in November, January 9, 2008, Delhi State Consumer Commission fined ICICI Bank, India’s largest privately owned bank by market value for what a judge called ‘the grossest kind of deficiency in service, unfair trade practice. ICICI Bank has appealed the decision to the Delhi High Court arguing the consumer

court doesn’t have the authority to impose such a large fine and that the collection agency should be held responsible for the attack, not the bank.

“While India’s overall percentage of non-performing loans is low – about 2.5% of all outstanding loans – the absolute number of all outstanding bad retail loans is growing with increased lending.”

“ICICI Bank has been India’s most aggressive bank in the retail market, using the internet, phone banking and automated teller machines to target the increasingly affluent middle class. The report cited rising interest rates as the major factor affecting borrowers’ ability to repay.

“The glorious run of an ever-improving NPL (non-paying loan) ratio that began in the late 1990s when the ratio was more than 15%, before falling to 2.5% in 2007, may just be over, the report says. Loans are typically classified as nonperforming if a customer fails to make payments for 90 days. At that point banks are supposed to issue legal notices to those in default. But because it can take years to pursue a debtor through India’s turgid legal system, many banks hire outside collection agents.

“That’s where the trouble starts. Increasingly, critics say, loan recovery has involved the use of strong arm tactics by goondas methods. While allegations of strong-arm tactics are not new in India – collection agents working for Citibank faced similar accusations in the 1990s – the practice has grown more prevalent with the boom in retail lending. Increasing violence associated with loan collections have spurred India’s central bank to crack down.

Draft guideline issued by the central bank in November on the matter of using collection agents warn banks that in cases of persistent abusive practices, the RBI could impose as temporary or even permanent ban on hiring outside agents, who so far have not been subject to regulation. The guidelines also call for a minimum of 100 hours of training for recovery agents as well as recommending the use of Lok Adalats, a sort of people’s court where disputes are solved by direct talk between litigants to settle defaults. The Supreme Court has also weighed in ruling that banks cannot engage goondas. Since the thugs have criminal records, banks are told by the police to have their collection agents vetted by them.■